Tax credit and tax deferral in parallel: China's new tax incentive policies for foreign investors' domestic reinvestment

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In brief

On June 27, 2025, the Ministry of Finance (MOF), the State Taxation Administration (STA) and the Ministry of Commerce (MOC) jointly issued the *Public Notice regarding Tax Credits for Foreign Investors' Direct Reinvestment of Distributed Profits*[1] (MOF, STA and MOC Public Notice [2025] No.2, hereinafter referred to as PN2), which introduces an additional tax incentive for foreign investors to reinvest profits distributed by Chinese resident enterprises.

PN2 applies to domestic direct investments made on or after January 1, 2025. PwC recommends that relevant foreign investors monitor the upcoming supporting administrative regulations for PN2, assess the policy benefits of tax deferral and credits in conjunction with their investment plans and return on investment, and make optimal use of the tax incentives. Additionally, they should pay close attention to the post-incentive follow-up management; if there is a change in the status of reinvestment, they must promptly settle any payable taxes to avoid compliance risks.

In detail

I. Tax Credit Vs. Tax Deferral

Prior to the issuance of PN2, Caishui [2018] No. 102[2] (hereinafter referred to as C102) had been in effect for many years. Under C102, foreign investors were allowed to defer payment of withholding tax on profits reinvested in China. In the event of investment recovery, the foreign investor is required to file and settle the deferred tax.

Building on the tax deferral treatment under C102, PN2 further introduces a tax credit mechanism. Specifically, **foreign investors who reinvest profits distributed by Chinese resident enterprises into qualified domestic direct investments during the period from January 1, 2025, to December 31, 2028, and meet conditions, such as a minimum 5-year investment period, will be granted a tax credit. The credit amount equals 10% of the reinvestment amount (or the preferential dividend tax rate specified in the applicable tax treaty, if lower than 10%)**.

This tax credit may be used to offset the foreign investor's corporate income tax liabilities arising from dividends, interest, royalties, or other income derived from the profit-distributing enterprise in the same year.

Any unused portion of the credit may be carried forward to subsequent tax years. If the investment period is less than 5 years, the foreign investor is required to repay the tax credit already claimed.

Overall, the requirements for the reinvestment tax credit are closely aligned with those for tax deferral, albeit **with stricter conditions** (see Part II for details). Investors who qualified for tax deferral under previous policies are not necessarily eligible for the new reinvestment tax credit policy. Conversely, foreign investors meeting the tax credit criteria under PN2 are deemed to satisfy the tax deferral requirements. This means that once the policy takes effect, foreign investors reinvesting profits within the eligible scope in China can simultaneously enjoy both deferred withholding tax and credit-based tax reductions, which will significantly encourage long-term foreign investment in China.

II. Reinvestment Tax Credit

To qualify for the reinvestment tax credit, foreign investors must satisfy **all of** the following five conditions:

1) **Profit Source:** The profits distributed to foreign investors must constitute equity investment income (e.g., dividends, bonuses) derived from **retained earnings actually distributed** by Chinese domestic resident enterprises. This aligns with the provisions of C102. If PN2 adopts the interpretation of profit source requirements under the tax deferral policy — as outlined in the STA's tax policy briefing Q&A session in the first quarter of 2018 — "Retained earnings actually distributed" should include undistributed retained earnings from prior years and the portion of liquidation proceeds attributable to dividends or other equity investment income. Unrealized pre-distribution amounts are excluded.

2) **Forms of Investment:** Foreign investors' domestic **direct investments** using distributed profits include the following:
   - Increasing or converting into the paid-in capital or capital reserve of resident enterprises in China;
   - Establishing new resident enterprises in China;
   - Acquiring equity in domestic resident enterprises from third parties.

   "Domestic resident enterprises" refer to resident enterprises established within China, excluding those established outside China but holding a Chinese tax resident certificate. PN2 covers most channels for foreign investors' investments in China. However, to prevent misuse of the incentive, it clarifies that the above investments exclude the issuance of new shares, capital increases through capital reserve conversion, or acquisitions of listed company shares (except for qualified strategic investments).

   In practice, some foreign investors operate through multi-layered overseas structures. These investors may repatriate profits to their parent companies, which then reinvest in China. While such arrangements ultimately channel profits from domestic enterprises into domestic reinvestment projects, they may not qualify for preferential policies, as they do not constitute "direct investment".

3) **Fund Transfer Requirements:** To ensure that profits distributed to foreign investors are actually used for direct investment, PN2 and C102 set forth similar requirements for the transfer of reinvested funds. Specifically:
   a) Where foreign investors use cash profits for domestic direct investment, such funds must be directly transferred from the profit-distributing enterprise's account to the invested enterprise's account or the equity transferor's account, with no circulation through other accounts (whether domestic or overseas) prior to the direct investment;
   b) Where foreign investors use non-cash profits (e.g., physical assets or securities) for domestic direct investment, the ownership of the relevant assets must be directly transferred from the profit-distributing enterprise to the invested enterprise or the equity transferor and must not be held in trust or temporarily by other enterprises or individuals prior to the direct investment.

4) **Investment Industry:** To promote industrial upgrading and guide foreign investment toward encouraged sectors, PN2 imposes restrictions on the industries eligible for reinvestment. It stipulates that, during the period of foreign investors' domestic reinvestment, the industries in which the invested enterprises operate must fall under **the national level encouraged foreign investment industries listed in the *Catalogue of Encouraged Industries for Foreign Investment*** (note: excluding region-specific encouraged industries listed in the same catalogue).

   This differs from C102, which merely requires the invested projects and sectors not to be prohibited to foreign investment. As a result, the industry requirements for qualifying for the reinvestment tax credit are more stringent than those for tax deferral. Additionally, further clarification is needed on how to determine whether an invested enterprise operates within the encouraged industries, as well as how to handle situations where the encouraged industry list is updated after the reinvestment is made.

5) **Investment Period:** Since C102 only provides for tax deferral, it does not impose holding period restrictions on reinvested profits. By contrast, the reinvestment tax credit requires foreign investors to hold their domestic reinvestments for **a continuous period of at least 5 years (60 months)**. In other words, the policy offers a permanent tax credit in exchange for a 5-year holding commitment, thereby encouraging foreign investors to make long-term, stable investments in China.

III. Creditable Taxable Amount and Credit Amount

Foreign investors who meet the above conditions for domestic reinvestment may claim a tax credit against their annual taxable income in accordance with the following provisions:

1) **Creditable Taxable Amount:** The creditable taxable amount refers to the corporate income tax payable by foreign investors on income—such as dividends, interest, and royalties—**specified in Article 3, Paragraph 3 of the *Corporate Income Tax Law* (i.e., income subject to withholding at source)** that is derived from **the profit-distributing enterprise after the date of reinvestment of distributed profits**. Notably, the creditable scope is subject to three requirements: nature, source, and timing. It excludes:
   - Income not subject to withholding at source (e.g., service fees and permanent establishment (PE) income);
   - Income paid by domestic enterprises other than the profit-distributing enterprise;
   - Income prior to the reinvestment date.

   It remains unclear whether equity transfer proceeds received by foreign investors from the profit-distributing enterprise, or deemed investment transfer proceeds arising during liquidation, qualify as creditable taxable income. Additionally, if an overseas shareholder reinvests only a portion of the distributed profits and remits the remaining dividends overseas, it remains to be clarified whether the corporate income tax payable on the non-reinvested portion can be immediately offset by the credit generated from the reinvested portion (specifically, if dividends are actually paid after the reinvestment date, can they be deemed as dividends received after that date?).

   Foreign investors should distinguish between funds from these two different sources, pay attention to provisions in supporting administrative regulations, and comply with procedural and documentation requirements.

2) **Determination of the Tax Credit and Its Carryforward:** Foreign investors may claim a tax credit equivalent to 10% of the qualified reinvestment amount against their annual taxable income. Any unutilized credit may be carried forward indefinitely to subsequent tax years.

   As the policy is structured to use withholding tax on dividends from profit distributions to incentivize domestic investment, PN2 stipulates that if the reduced tax rate for dividends under Sino-foreign tax treaties is lower than 10%, the treaty rate shall apply. However, considering that the eligibility for reduced treaty rate in respect of dividends is subject to a beneficial owner assessment, tax authorities have yet to clarify whether the assessment of a foreign investor's beneficial owner status should be factored into in determining the credit amount, or if the reduced treaty rate should apply regardless of the beneficial owner status.

   If the credit rate is inconsistent with the applicable tax rate for dividends paid upon future recovery of the investment, foreign investors may either fail to receive adequate preferential treatment or be granted undue preferential treatment.

IV. Deferred Tax Filing and Repayment of Tax Credit when Recovering Reinvestments

If foreign investors recover their investments after claiming a tax credit, they may be required to pay the deferred tax. C102 clarifies that "investment recovery" includes equity transfers, repurchases, liquidations, or other methods that effectively recover direct investments benefiting from preferential policies. This interpretation will most likely also apply to the relevant tax credit provisions under PN2.

Under PN2, the tax treatment for investment recovery falls into two scenarios:

1) **Recovery of Full or Partial Direct Investment After 5 Years (60 Months):** PN2 stipulates that "for distributed profits of the domestic resident enterprise corresponding to the recovered investment, the foreign investor shall, within 7 days of recovering the investment, file and settle the deferred tax with the tax authority where the profit-distributing enterprise is located. Any unutilized reinvestment tax credits may be used to offset its tax payable."

   If the foreign investor has not utilized the tax credit prior to recovering the investment, and the applicable rate for the credit align with the rate applicable to the deferred tax payment, the final tax payable will be zero. This effectively exempts the foreign investor from withholding tax on the distributed profits corresponding to the investment after the 5-year period.

2) **Recovery of Direct Investment Within 5 Years (60 Months):** PN2 stipulates that “distributed profits of the domestic resident enterprise corresponding to the recovered investment shall be deemed to have failed to meet the preferential conditions for reinvestment tax credits. The foreign investor shall not only pay the deferred tax but also reduce the available tax credit amount proportionally. If the tax credit amount already utilized by the foreign investor exceeds the reduced credit amount, the investor shall repay the tax equivalent to the gap within 7 days.”

   This implies that foreign investors are not eligible for the tax credit if the investment period is less than 5 years. Consequently, they are required to repay the deferred tax and adjust the tax credit balance. If the tax credit has already been utilized, any excess portion must be repaid (separately from the deferred tax payment), and a late payment surcharge will be imposed. Given the high rate of such surcharges, foreign investors should carefully assess the risks before electing to claim the reinvestment tax credit under PN2.

Consistent with the provisions of C102, if the direct investment recovered by a foreign investor includes both investments for which tax credits have been claimed and those for which they have not, the investments with claimed tax credits shall be deemed to be disposed of first.

If the invested enterprise undergoes a restructuring that meets the criteria for special restructuring and has been taxed in accordance with special restructuring regulations, the foreign investor may continue to enjoy tax deferral and claim tax credits and is not required to pay the deferred taxes or repay the credit amount at this time.

Additionally, PN2 further clarifies that in cases of partial investment recovery, only the portion corresponding to the recovered investment is subject to tax payment and tax credit reduction, rather than requiring full payment or full credit reduction. This is beneficial to taxpayers.

Illustration

Foreign Company A is engaged in the R&D, production, and sales of chemical products. In 2016, it established a wholly foreign-owned enterprise (WFOE B) in China. In recent years, as China’s market has developed rapidly, Company A established another wholly foreign-owned enterprise (WFOE C) in China in 2023, with an investment of RMB 8 million to produce chemical auxiliary products.

In 2026, WFOE B achieved strong profitability and resolved to distribute RMB 10 million in dividends to Company A from its retained earnings. Concurrently, Company A decided to inject the dividend-derived funds into WFOE C, increasing WFOE C’s paid-in capital to RMB 18 million. The jurisdiction where Company A is located does not have a preferential dividend tax rate under its tax treaty with China.

If the following three conditions are met:

- Company C operates within the industries listed in the national level encouraged foreign investment catalogue;
- Profit funds are transferred to Company C in a manner compliant with PN2 requirements;
- Company A holds its investment in Company C for a period exceeding 5 years (60 months).

then Company A may:

- Enjoy tax deferral: Company B temporarily does not have to withhold the corporate income tax (i.e., RMB 10 million × 10% = RMB 1 million) on the dividend income to be distributed to Company A in 2026.
- Obtain tax credit: Company A is entitled to a tax credit equal to 10% of the reinvestment amount (i.e., RMB 10 million × 10% = RMB 1 million), which can be used to offset either the withholding tax on income withheld at source from Company B or the deferred withholding tax to be repaid upon investment recovery.

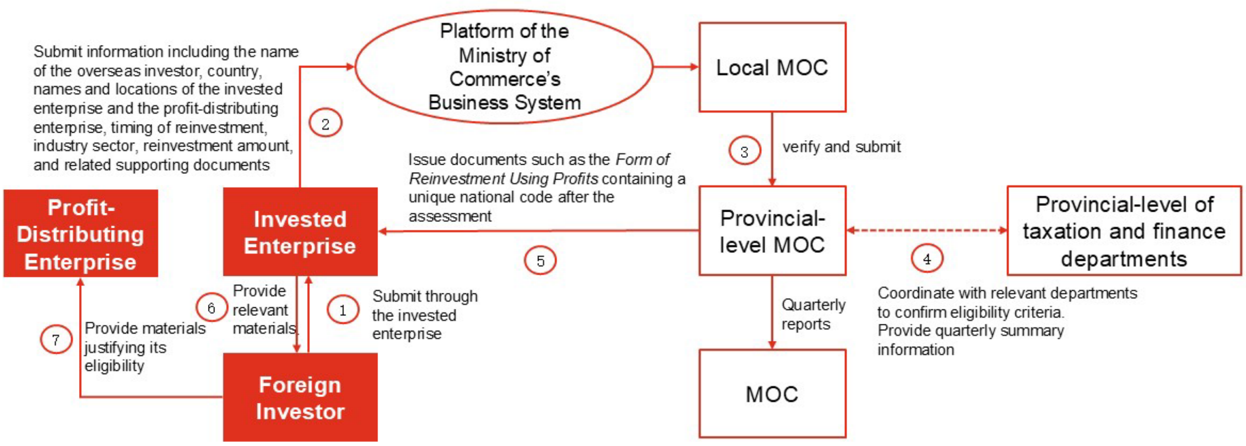
PwC has analyzed the tax liabilities under four scenarios, based on the holding period duration and credit utilization.

	Scenarios	Tax implications
Scenario 1: Full recovery of reinvestment after 5 years, with unused tax credit prior to recovery	• From 2026 to 2032, Company B did not distribute dividends or remit payment which should be subject to withholding tax at source such as interest or royalties to Company A.	Since Company A has recovered its equity investment in Company C, it is required to pay the deferred corporate income tax of RMB 1 million. This tax liability can be fully offset by the RMB 1 million tax credit derived from the reinvestment. As

	• In 2032, Company A transferred all equity in Company C and such equity transfer does not qualify for special tax treatment (the same below).	a result, the actual tax paid by Company A on the dividend income received in 2026 is zero.
Scenario 2: Full recovery of reinvestment after 5 years, with tax credit utilized prior to recovery	• In 2030, Company B paid royalties of RMB 3 million to Company A. • In 2032, Company A transferred all its equity in Company C.	• In 2030, Company B was obligated to withhold RMB 300,000 of corporate income tax for Company A (i.e., RMB 3 million × 10% = RMB 300,000). At the same time, a tax credit of RMB 300,000 could be utilized, with the remaining credit of RMB 700,000 eligible for carryforward to subsequent years. As a result, the actual withholding income tax paid by Company B in 2030 is zero. • In 2032, since Company A recovered its equity investment in Company C, it is required to pay the deferred corporate income tax of RMB 1 million. This tax liability could be offset by the carried-forward tax credit of RMB 700,000. Consequently, the actual corporate income tax paid by Company A in 2032 is RMB 300,000.
Scenario 3: Full recovery of reinvestment within 5 years, with unused tax credit prior to recovery	• Due to market changes, Company A adjusted its business strategy and transferred all its equity in Company C in 2028. • From 2026 to 2028, Company B did not distribute dividends to Company A or remit payments subject to withholding at source (such as interest or royalties).	Since Company A held its equity in Company C for less than 5 years, it is required to adjust the tax credit amount down by RMB 1 million and pay the deferred corporate income tax of RMB 1 million. Accordingly, in 2028, Company A is obligated to pay the deferred corporate income tax of RMB 1 million.
Scenario 4: Full recovery of reinvestment within 5 years, with tax credit utilized prior to recovery	• Due to market changes, Company A adjusted its business strategy and transferred all its equity in Company C in 2028. • In 2027, Company B paid royalty payments of RMB 3 million to Company A.	• In 2027, Company B withheld corporate income tax of RMB 300,000 for Company A (i.e., RMB 3 million × 10% = RMB 300,000). In the same year, a tax credit of RMB 300,000 was utilized, resulting in an actual withholding tax payable of zero. Additionally, the remaining tax credit of RMB 700,000 could be carried forward to subsequent tax years. • Since Company A held its equity in Company C for less than 5 years, it is obligated to adjust the tax credit amount down by RMB 1 million and pay the deferred corporate income tax of RMB 1 million. However, in 2028, Company A only retained a tax credit of RMB 700,000, which was insufficient to cover the repayment amount. The shortfall (RMB 300,000) had to be repaid, and a late payment surcharge would be levied. Consequently, Company A's total liability for 2028 amounted to RMB 1.3 million (i.e., RMB 1 million + RMB 300,000 = RMB 1.3 million), with late payment surcharge calculated on the portion of RMB 300,000.

V. Claiming the Tax Credit

The domestic reinvestment tax credit follows a conditional confirmation process involving three administrative authorities: commerce, finance, and taxation. An illustrative diagram of the tax credit claim process is as follows:



As shown in the diagram above, the entire process requires collaboration among foreign investors, invested enterprises, and profit-distributing enterprises.

1) **Foreign Investors**
   - **At the time of investment:** Submit information and supporting documents including the foreign investor's name and country, the names and locations of the invested enterprise and profit-distributing enterprise, the timing of reinvestment, the industry sector, and the reinvestment amount, through **the invested enterprise to the local MOC** via the MOC Business System Platform (Foreign Investment Comprehensive Management Application).
   - **At the time of investment:** Provide supporting documents **to the profit-distributing enterprise** in accordance with tax administration regulations.
   - **Upon investment recovery:** Submit information, including the foreign investor's name and country, the names and locations of the invested enterprise and profit-distributing enterprise, the recovery time, the industry sector, and the amount **through the invested enterprise to the local MOC** via the MOC Business System Platform (Foreign Investment Comprehensive Management Application).

2) **Invested Enterprises**
   - **At the time of investment:** The invested enterprise assists the foreign investor in submitting relevant information to the MOC. After verification by the MOC at the invested enterprise's location, the information is submitted to **the provincial-level MOC**. Following internal eligibility checks with **the same-level finance, taxation, and other relevant departments**, the provincial-level MOC issues documents—including **the *Form of Reinvestment Using Profits*** containing a unique national code to the invested enterprise, which then forwards the relevant materials **to the foreign investor**.

3) **Profit-distributing Enterprises**
   - **At the time of investment:** Upon receiving documents from the foreign investor that can justify the eligibility of claiming tax credit, the profit-distributing enterprise temporarily does not have to withhold the corporate income tax on the reinvested profits.
   - **At the time of remittance:** When profit-distributing enterprises remit dividends, interest, royalties, etc. to foreign investors, they shall withhold the corporate income tax based on the amount remaining after offsetting the tax credit.

PN2 does not specify the procedures for profit-distributing enterprises to defer and offset withholding tax, nor does it clarify the responsibilities and obligations of the three parties (e.g., whether profit-distributing enterprises or invested enterprises are required to verify the documents provided by foreign investors). It is anticipated that upcoming supporting tax administration regulations will address these points.

VI. The effective period and retrospective application

The domestic reinvestment tax credit policy shall be effective from January 1, 2025, to December 31, 2028. More specifically:

- Tax credit policy for qualifying reinvestments made between January 1, 2025, and the issuance date of PN2 (i.e., June 27, 2025) may be applied retrospectively. However, such tax credits can only be used to offset income tax liabilities arising after the issuance date (i.e., June 27, 2025).
- Any unused credit balance remaining after the policy expires on December 31, 2028, may continue to be utilized until fully depleted.

The reinvestment date is critical both for determining whether an investment "occurs" within the effective period and for identifying eligible income for tax credit claims. Given that several dates are associated with reinvestment — including the investment agreement signing date, the date of filing with the MOC, the legal registration date, and the issuance date of the *Form of Reinvestment Using Profits* — it remains unclear which date should be recognized as the reinvestment date. Foreign investors must monitor upcoming administrative regulations to assess their eligibility for the new policy.

The takeaway

The tax credit policy for reinvestment represents a key measure by China to continuously expand high-level opening-up and encourage foreign investment. It sends a positive signal of China's commitment to encouraging foreign investment, strengthening foreign investors' confidence in investing in China, and motivating them to participate more actively in the Chinese market. This constitutes a significant positive development for foreign investors willing to make long-term, stable investments in China.

Building on the previous tax deferral policy for reinvestment, PN2 further introduces a tax credit policy. On the one hand, it reduces the tax burden on foreign investors engaged in long-term investments; on the other hand, it imposes higher requirements on reinvestment activities. To claim the tax credit, foreign investors should pay attention to the requirements for accessing this preferential treatment (such as eligible investment sectors and periods), application procedures, and relevant timelines. Notably, the latest version of the *Encouraged Industry Catalogue for Foreign Investment* is currently open for public consultation and is expected to take effect soon. It differs from the current *Encouraged Industry Catalogue for Foreign Investment* in terms of covered industries, therefore foreign investors should take this into account when conducting self-assessments.

The upgrading of tax incentives may be accompanied by stricter post-implementation supervision. Foreign investors should conduct advance self-assessments and reviews. After availing themselves of the incentives, they should also continue to monitor the recovery status of reinvestment projects. In the event of any investment recovery, they must promptly adjust the credit balance or settle any outstanding taxes in accordance with the regulations to avoid incurring late payment surcharges.

In addition, the domestic reinvestment tax credit may affect the effective tax rate of Chinese constituent entities under Pillar Two. Given that Pillar Two has already taken effect in many jurisdictions, multinational enterprise groups are advised to further evaluate the potential impact of this policy on the top-up tax under Pillar Two.

Endnote

1. *Public Notice Regarding Tax Credit for Direct Re-investment of Foreign Investors Using Profits Distributed from Tax Resident Enterprises (TREs) in China*
   https://www.gov.cn/zhengce/zhengceku/202507/content_7030227.htm

2. *Notice Regarding Expanding the Applicable Scope of Provisional Deferral Treatment for Withholding Tax on Direct Re-investment of Foreign Investors Using Profits Distributed from Tax Resident Enterprises in China*
   https://www.gov.cn/zhengce/zhengceku/2018-12/31/content_5441290.htm

Let's talk

For a deeper discussion of how this impacts your business, please contact **PwC's China Tax and Business Service Team:**

Jeff Yuan
China Tax Leader
+86 (21) 2323 3495
jeff.yuan@cn.pwc.com

Peter Guo
China Tax Markets Leader
+86 (10) 6533 3415
p.guo@cn.pwc.com

Rex Chan
China North Tax Leader
+86 (10) 6533 2022
rex.c.chan@cn.pwc.com

Alan Yam
China Central Tax Leader
+86 (21) 2323 2518
alan.yam@cn.pwc.com

Jeremy Ngai
China South (incl. Hong Kong SAR) Tax Leader
+852 2289 5616
jeremy.cm.ngai@hk.pwc.com

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For more information, please contact:

Long Ma
+86 (10) 6533 3103
long.ma@cn.pwc.com

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