The Long Wait Is Over - Clarity on the Taxation of Capital Gains by QFIIs/RQFIIs in China

Contents

NOVEMBER 2014

QFII/RQFII Taxation

The Past

China's qualified foreign institutional investor ("**QFII**") program has granted foreign investors access to China's capital markets since 2002.[1] To date, more than three hundred international institutions comprising banks, fund management institutions, insurance companies, securities companies and other asset management companies have applied for and received approvals to invest in China as QFIIs or RQFIIs.[2] Over the years, the Chinese government has shown willingness to expand the QFII/RQFII programs by granting new investment quotas or allowing existing participants to increase their quotas, but for reasons that have never been entirely clear, one area that has always lagged behind has been the taxation of QFIIs/RQFIIs. One reason may be that the two government agencies involved, CSRC [3] and State Administration of Taxation ("**SAT**") [4], reportedly had different views on whether QFIIs/RQFIIs should be taxed in China. This is because CSRC's goal is to attract foreign investors to participate in China's capital markets by providing a tax-friendly environment, while SAT's goal is to collect taxes from all investors, foreign and domestic.

Up until October of this year, only two tax circulars had been issued on QFII/RQFII taxation in China which, given the relatively long period since the QFII regime was set up, is somewhat surprising: one addressing the exemption of business tax on the trading income derived by a QFII from securities trading activities in China, and the other addressing withholding tax on dividends and interest paid to QFIIs/RQFIIs. However, the issue of taxation on capital gains, which is perhaps the key tax-related concern of any investor in the securities markets, has never been addressed by the Chinese tax authorities. The only exception to this was in a case in 2010 involving the Beijing State Tax Bureau reportedly levying about RMB399 million of tax on the capital gains derived by the Lehman Brothers' QFII on the liquidation of its portfolio to bolster the bankruptcy estate. Against the backdrop of the general principles found in the *People's Republic of China Enterprise Income Tax Law* ("**EIT Law**") in China [5], many tax practitioners and investors viewed the Lehman Brothers' case as a clear indication that QFIIs/RQFIIs would be subject to PRC income tax on capital gains and that it would only be a matter of time before the Chinese tax authorities would expand the collection net to all QFIIs/RQFIIs. Some QFIIs/RQFIIs even took the step of setting aside cash for potential tax liabilities on capital gains even though there have been no reported examples since the Lehman Brothers' case where a QFII/RQFII has been subjected to tax in China on its capital gains.

The Present

The SAT, together with Ministry of Finance ("**MOF**") and CSRC, executed a somewhat unexpected 180 degree turn on the taxation of capital gains derived by QFIIs/RQFIIs in a recent circular issued on 31 October.[6]

---

1 The Renminbi QFII program was introduced in 2011 ("**RQFII**") which allows a licensed RQFII to raise Renminbi funds offshore and invest directly into securities markets in China upon approval by the China Securities Regulatory Commission ("**CSRC**") and the State Administration of Foreign Exchange ("**SAFE**").

2 According to the CSRC website, as of 30 September 2014, 269 QFIIs and 98 RQFIIs had received approval.

3 CSRC is the government agency responsible for regulating the securities industry in China

4 SAT is the government agency responsible for tax enforcement in China.

5 The EIT Law and its implementing regulations provide that a non-resident taxpayer without an establishment in China is subject to a 10% income tax on China-sourced capital gains, unless such income is exempt under an applicable double tax treaty. The 10% income tax is usually levied on a withholding basis.

6 *Circular on the Issues of Temporary Enterprise Income Tax Exemption for Gains Derived from the Transfer of PRC Shares and other Equity Investment Assets by QFIIs and RQFIIs* (Cai Shui [2014] No. 79), issued by the MOF, SAT and CSRC on 31 October 2014 and effective 17 November 2014 ("**Circular 79**").

According to Circular 79, capital gains derived by QFIIs/RQFIIs from the sale of Chinese equity investments (including shares) will be temporarily exempt from income tax (withholding tax) in China if:

- the capital gain is derived on and after 17 November 2014; and
- the QFIIs/RQFIIs do not have an establishment or place of business in China[7] or if the QFIIs/RQFIIs have an establishment or place of business in China, the gains are not effectively connected with that establishment or place of business.

Circular 79 further provides that capital gains derived by QFIIs/RQFIIs from the sale of Chinese equity investments from before 17 November 2014 are still taxable in China.

Circular 79 was issued on the same day that the long-awaited taxation policy for the pilot Shanghai-Hong Kong Stock Connect Scheme[8] ("**SHSC Scheme**") was issued. This clearly was no coincidence and China may have simply decided to deal with them together as according to an Q&A posted on SAT's website, the aim is to have a similar tax policy for both QFIIs/RQFIIs and the SHSC Scheme, although given the investor base, one could argue that QFII/RQFII and the SHSC Scheme are very different in nature.[9]

The Future

Circular 79 provides long overdue and welcome clarity on the taxation of QFIIs/RQFIIs in China although further details remain to be bottomed out. For example, how long will the temporary exemption last? For QFIIs/RQFIIs that derived capital gain from before 17 November 2014, how will the capital gain be calculated, on a transaction-by-transaction basis or on the basis of a QFII/RQFII's overall net position? What are the criteria to determine whether a QFII/RQFII has an establishment or place of business in China – will a QFII/RQFII be assessed based on the "establishment or place" criteria in the EIT Law or if a QFII/RQFII is a tax resident of a jurisdiction that has concluded a double tax treaty (or equivalent) with China, will it be assessed based on the PE criteria in that treaty?

In theory, it should not be difficult for a QFII/RQFII to avoid having an establishment or place of business in China. This is because a QFII must appoint a commercial bank in China to act as its custodian bank and appoint a securities company in China as its broker to handle its domestic securities trading activities. In a typical QFII/RQFII trading model, foreign investors will invest funds through a QFII/RQFII, the QFII/RQFII will wire the required funds to a custodian bank in China, and the QFII/RQFII fund manager will place orders electronically with an approved broker in China. After the broker has executed the orders on the stock exchange, the QFII/RQFII securities account will be credited or debited with the securities purchased or sold by the clearing and registration organization in China so a QFII/RQFII using a pure offshore model does not need to have a presence in China as all the trading activities can be conducted remotely electronically. However, as QFIIs/RQFIIs also need to conduct research to support any investment and need to carry out site visits and onsite management meetings in China, the question still remains whether these activities could trigger an establishment or place/PE and if a QFII/RQFII is a tax resident of a jurisdiction that has concluded a double tax treaty (or equivalent) with China, whether the Chinese tax authorities would view these activities as the "preparatory or auxiliary" exceptions to the rules on the creation of a PE.

Conclusion

Although many questions about QFII/RQFII taxation remain unanswered by Circular 79, Circular 79 nevertheless brings some long-awaited clarity on the taxation of capital gains in the hands of QFIIs/RQFIIs. The cut-off date of 17 November 2014 seems rather arbitrary, although perhaps the intention was simply to coincide with the launch date of the SHSC Scheme but there seems to be no obvious logic as to why prior gains remain taxable and those after the cut-off date are not.

[7] The concept of "establishment or place" under PRC domestic law is broadly similar to the concept of "permanent establishment" ("**PE**") found in double tax treaties.

[8] Allowing eligible Chinese investors to invest in eligible securities on the Hong Kong securities market and eligible investors in Hong Kong to invest in eligible securities listed on the Shanghai Stock Exchange ("**SSE**") via their home market clearing systems.

[9] The tax policy for the SHSC Scheme provides that effective from 17 November 2014, capital gains derived through the SHSC Scheme from the sales of A shares traded in the SSE are exempt from income tax. In addition, net revenue derived through the SHSC Scheme from sales of A shares traded on the SSE are exempt from business tax. The tax policy for Chinese investors investing in eligible securities on the Hong Kong securities market is not discussed in this alert.

The temporary nature of the going forward exemption also makes business planning more challenging, as contingency funds may still need to be set aside given the fact that no-one knows when the exemption will end and whether retroactive taxation may apply at that point. It would have been helpful to have had some sort of time frame on the duration of the exemption. However as with many things in China, you need to take one step at a time and at the very least, it is now clear that the capital gains made by QFIIs/RQFIIs before 17 November of this year are subject to tax on capital gains in China.

Contacts

Andrew McGinty
+86 21 6122 3866
andrew.mcginty@hoganlovells.com

Roberta Chang
+86 21 6122 3861
roberta.chang@hoganlovells.com

www.hoganlovells.com

Hogan Lovells has offices in:

Alicante	Dusseldorf	London	New York	Silicon Valley
Amsterdam	Frankfurt	Los Angeles	Northern Virginia	Singapore
Baltimore	Hamburg	Luxembourg	Paris	Tokyo
Beijing	Hanoi	Madrid	Philadelphia	Ulaanbaatar
Brussels	Ho Chi Minh City	Mexico City	Rio de Janeiro	Warsaw
Budapest*	Hong Kong	Miami	Riyadh*	Washington DC
Caracas	Houston	Milan	Rome	Zagreb*
Colorado Springs	Jakarta*	Monterrey	San Francisco	
Denver	Jeddah*	Moscow	São Paulo	
Dubai	Johannesburg	Munich	Shanghai	

*Associated offices