The long-awaited withholding tax policies for QFIIs/RQFIIs capital gains released – mixed feelings?

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In brief

The Ministry of Finance (MOF), State Administration of Taxation (SAT) and China Securities Regulatory Commission (CSRC) jointly promulgated the tax policies for the scheme of Shanghai-Hong Kong Stock Connect[1] on 14 November 2014, right before its launch on 17 November 2014. At the same time, these authorities also published the circular entitled Caishui [2014] No.79 (Notice 79) to provide long-awaited clarification on withholding tax (WHT) policy for capital gains in relation to QFIIs / RQFIIs schemes.

Under Notice 79, QFIIs /RQFIIs are temporarily exempt from WHT on gains derived from the trading of equity investment assets (including shares) effective from 17 November 2014, which is largely the same as that for the scheme of Shanghai-Hong Kong Stock Connect. Apparently, the aim of Notice 79 is to make the tax treatments for all such investment schemes at par. This should be a tax policy welcomed by QFIIs/RQFIIs.

However, it was also stipulated in Notice 79 that QFIIs and RQFIIs shall be subject to WHT on their capital gains derived before 17 November 2014. This answered a very important question that many QFIIs/RQFIIs have been asking, but it still leaves a number of key tax issues that QFIIs/RQFIIs should consider and the Chinese tax authorities should clarify.

In detail

Recap of the prevailing tax policies and practice before Notice 79

Under both the former Foreign Enterprise Income Tax (FEIT) (pre-2008) and new Corporate Income Tax (CIT) regimes (post-2007), capital gains from trading of A shares of Chinese domestic listed companies by QFIIs/RQFIIs were treated as China-sourced income, and thus subject to WHT under both FEIT or CIT regimes in China.

Prior to 2008, the temporary WHT exemption provided under Circular Guoshuifa [1993] No.45 did not address A-share capital gains derived by QFIIs. Afterwards, two QFII-specific tax circulars were issued, namely Caishui [2005] No. 155 and Guoshuihan [2009] 47[2] (Circular 47). However, both circulars were silent on the WHT treatment for capital gains on A shares derived by QFIIs. Since the inception of RQFII scheme in Hong Kong in 2011, the Chinese tax authorities have not promulgated a clear cut policy to address this aspect.

Despite the generic tax policy under the FEIT and CIT regimes, the real-life practice since the inception of QFIIs back in 2003 has indicated that the Chinese tax authorities have not actively collected WHT on capital gains on A shares derived by QFIIs/RQFIIs (except for a reported QFII liquidation case). This was probably because most QFIIs/RQFIIs have yet to arrange for the outbound repatriation of their China-sourced income, namely the capital gains.

The long-awaited clarification on the outstanding WHT issue for QFIIs/RQFIIs was becoming more and more pressing when China's A-share market was open to a wider range of QFIIs and then RQFIIs in recent years.

Did Notice 79 provide sufficient clarification?

Along with the launch of the landmark Shanghai-Hong Kong Stock Connect on 17 November 2014, Notice 79 stipulated that QFIIs /RQFIIs without an establishment or place (E&P) in China, or QFIIs / RQFIIs with E&P in China but the income so derived in China is not effectively connected with their E&P, are temporarily exempt from WHT on gains derived from the trading of equity investment assets (including shares) effective from 17 November 2014. This temporary exemption on capital gains for QFIIs/RQFIIs was offered so that they can start on a level playing field with the Shanghai-Hong Kong Stock Connect scheme from its launch. This blanket tax exemption for QFIIs/RQFIIs (and effectively for their investors) is consistent with international practices and has sent a reinforcing signal on the promotion of China's A-share market and internationalisation of the Renminbi.

However, it is imperative to note that the exemption is made as a temporary measure. Hence it is unclear how long the exemption will be in place and what should be the grandfathering protection if the exemption is eventually removed.

On the other hand, Notice 79 now clearly stipulates that QFIIs / RQFIIs shall be subject to WHT in respect of the capital gains derived pre-17 November 2014. It answered a very important question that many QFIIs/RQFIIs (and their investors) had been asking over the years. However, it still leaves open the following key tax issues that QFIIs/RQFIIs should consider and Chinese tax authorities should clarify.

Key tax issues for pre-17 November 2014 capital gains

The key tax issues can be summarised as follows:

- How to determine the gains "derived" before 17 November 2014?[3]
- What is the scope of capital gains (What are equity investment assets)?[4]
- What are the criteria for determining whether or not a QFII/RQFII has an E&P in China? What are the criteria for determining whether or not capital gains are effectively connected to the E&P if the QFII/RQFII has an E&P in China?
- Is the effective date of taxation retrospective to the inception of QFIIs or starting from 2008 (the commencement of the new CIT regime)? Will late payment surcharges be imposed?
- Are QFIIs / RQFIIs (or their investors) eligible for treaty protection? If they are, what are the application procedures?
- On what basis should capital gains be calculated (mainly trade-by-trade basis vs. netting basis)?
- What are the tax administration procedures (when to pay the WHT, which tax bureaus, and who would be the withholding agent)?

The takeaway

Notice 79 gives QFIIs / RQFIIs mixed feelings, especially QFIIs who have been in existence for a long time. On one hand, the market should applaud China's decision to offer a blanket tax exemption (though temporary) to make the WHT treatment for QFIIs / RQFIIs on par with those for the Shanghai-Hong Kong Stock Connect scheme on and after 17 November 2014. On the other hand, QFIIs / RQFIIs are now certain that their capital gains derived prior to 17 November 2014 are subject to WHT. However, it is still not clear enough for the implementation details of tax payment procedures and treaty protection.

As for market products offered by QFIIs/RQFIIs to their investors, they should keep in mind the different tax treatments for capital gains derived before and after 17 November 2014 respectively, and make appropriate commercial arrangements and disclosures accordingly.

With the clarification of tax policies, we expect the Chinese tax authorities should be prepared to accept treaty applications for capital gains derived before 17 November 2014. Given there are different commercial arrangements between QFIIs/RQFIIs and their investors, each type of account should be assessed separately. Apart from that, reaching an agreement with the Chinese tax authorities on the list of land-rich listed shares is necessary, though burdensome.

Last but definitely not least, each QFII/RQFII must take immediate actions to assess their own situations and determine if they are sufficiently prepared for historical tax obligation (pre-17 November 2014) as provided by Notice 79.

Endnote

1. *For details of Stock Connect's taxation rules, our News Flash will be available shortly.*
2. *Caushui [2005] No. 155 exempts Business Tax on gains derived by QFII; and Guoshuihan [2009] No.47 requires Chinese listed companies issuing A shares to withhold tax at the rate of 10% on the payment of dividends, bonus profits and interest.*
3. *This question would have a symmetrical implication on what capital gains would be exempted after 17 November 2014.*
4. *Same as footnote 3.*

Let's talk

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