

Foreign institutional investors in China: Some taxation implications



In 2002, the China Securities and Regulatory Commission (CSRC) and the People's Bank of China granted foreign institutions direct access to China's capital markets. The tax implications of this legislation are still being understood.

Foreign fund management institutions, insurance companies, securities companies and other asset management organisations are eligible to apply for approval as a Qualified Foreign Institutional Investor (QFII) in China. As of October 2005, the CSRC has approved 30 QFIIs, with a total investment volume of US\$10 billion.

While the CSRC has the authority to approve an application, the State Administration for Foreign Exchange (SAFE) sets a foreign exchange investment quota. The QFII should appoint a domestic commercial bank as its custodian bank, and a domestic securities company to effect securities transactions (see diagram, *right*).

QFIIs may invest in the following renminbi-denominated financial products listed in the China stock exchanges:

- Shares
- Bonds
- Other financial instruments as approved by the CSRC

Income tax considerations

Investments by a QFII in shares and bonds will generate recurring income

streams and the possibility for capital gains. So who should pay the tax? If there is an investor behind the QFII, the QFII entity only acts as an investment flow-through vehicle.

Treating the QFII as a flow-through vehicle means, in substance, the beneficial owners are investors behind the QFII. The QFII may refer to a domestic fund where taxation falls on the investor, not the fund itself. Further, beneficial owners from certain countries may lose tax treaty benefits to which they would otherwise be entitled.

There is an argument for treating the QFII itself as the taxpayer, since the licence is given to the QFII for buy-sell transactions. But that entails practical difficulties. While it might be possible to create a system to keep track of the detailed trading transactions of owners, the cost of building and maintaining this infrastructure may be too high to justify.

Qualifying as a permanent establishment in China

If the QFII is the taxpayer, should it be taxed as resident or non-resident? According to article 3 of the Detailed Rules and Regulations on Implementation of Income Tax Law of The People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises:

“Establishment refers to management organisations, business organisations, representative offices... places where labour services are provided, and business agents.”

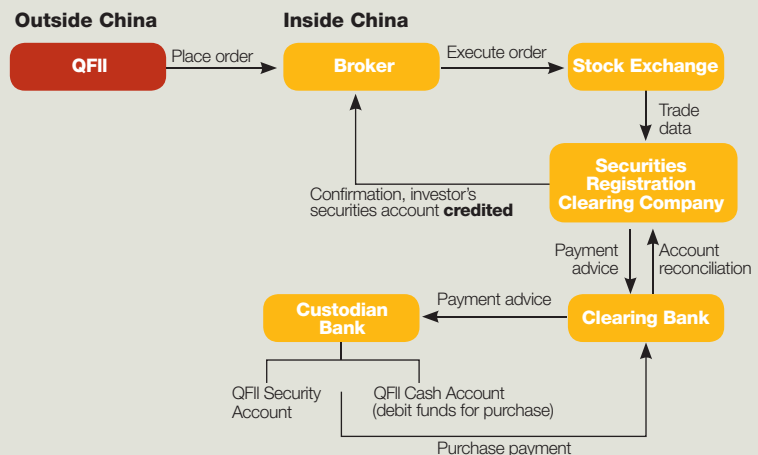
Many of China's tax treaties define this to include a fixed place of business. An analysis of the purchase and sales transaction flow of a QFII would indicate that a QFII does not have a fixed place of business in China, by virtue of its buy-sell model. Therefore, it does not fall under the criteria of a permanent establishment.

The operating model

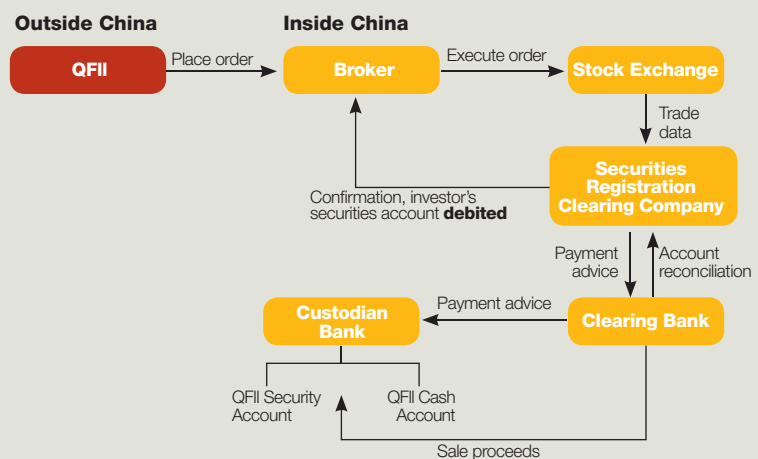
► The following diagrams illustrate how a purchase or sale transaction could be completed.

According to this model, orders are placed electronically by the QFII from other major financial markets with approved brokers in China. Orders are executed through the trading system of the Stock Exchange and the Securities Registration Clearing Corporation (SRCC). When an order is accepted, the stock exchange would instruct the broker and the SRCC. The SRCC would credit the QFII with the securities, and advise the custodian bank of the QFII for payment settlements. A sales transaction would be conducted similarly through electronic instructions. The QFII does not need to establish an office in China to complete the buy-sell transaction.

Share settlement cycle (purchase)



Share settlement cycle (sale)



Article 4 of the DRR defines business agents in the following way:

“Business agents refers to the operating companies, enterprises and other economic organisations or persons that maintain any of the following principal-agent relationship... three having the authority to represent the principal on a regular basis in signing sales contracts or accepting purchase orders.”

The broker or the custodian bank could be interpreted as a dependent agent, and hence qualify as a permanent establishment for the QFII. But since the approved securities brokers and custodian banks are organisations with substantial business interests, it's possible to argue that they do not constitute a business agent of the QFII.

Assuming the QFII has a permanent establishment in China, it would be subject to PRC Foreign Enterprise Income Tax on a net basis (taxable income less allowable expenses) and be taxed at 33 percent foreign enterprise income tax rate on its net taxable income.

If the QFII does not have a permanent establishment in China, its income dividend, interest and capital gain would be subject to the tax treatments applicable to passive income. In this case, the challenge is which tax law to apply to this. In China, there are two sets of enterprise income tax legislations: the Domestic Enterprise Income Tax Law 1994 (DEIT), and Income Tax Law of the PRC for Enterprises with Foreign Investment and Foreign Enterprise 1991 (FEIT). In this case, the payer is a domestic enterprise subject to DEIT, the recipient of income is a foreign enterprise, subject to FEIT. Under the FEIT legislation, there is no specific guideline as to whether the dividend tax exemption could be extended to dividends from A-shares to foreign investors.

Another issue arises in the case of capital gains where the QFII does not have a permanent establishment, whether capital losses could be set off against capital gains in calculating the gains for a non-resident QFII.

Registered QFIIs in China

- ★ UBS Limited
- ★ Nomura Securities Co., Ltd.
- ★ Citigroup Global Markets Limited
- ★ Morgan Stanley & Co. International Limited
- ★ Goldman Sachs & Co.
- ★ The Hongkong and Shanghai Banking Corporation Limited
- ★ Deutsche Bank Aktiengesellschaft
- ★ ING Bank N.V.
- ★ JP Morgan Chase Bank
- ★ Credit Suisse First Boston (Hong Kong) Limited
- ★ Nikko Asset Management Co., Ltd.
- ★ Standard Chartered Bank (Hong Kong) Limited
- ★ Hang Seng Bank Limited
- ★ Daiwa Securities SMBC Co., Ltd.
- ★ Merrill Lynch International
- ★ Lehman Brothers International (Europe)
- ★ Bill & Melinda Gates Foundation
- ★ INVESCO Asset Management Limited
- ★ ABN AMRO Bank N.V.
- ★ Société Générale Asset Management S.A.
- ★ Templeton Asset Management Limited
- ★ Barclays Bank PLC
- ★ Dresdner Bank Aktiengesellschaft
- ★ Fortis Bank S.A./NV
- ★ BNP Paribas
- ★ Power Corporation of Canada
- ★ CALYON S.A.
- ★ Goldman Sachs Asset Management International
- ★ Government of Singapore Investment Corporation
- ★ Martin Currie Investment Management Ltd.

Source: CSRC

Business tax

The Ministry of Finance and the State Administration for Taxation has jointly issued Circular *CaiShui* [财税 2005]155 on 1 December 2005 to exempt business tax on the gain on trading of securities. However, the basis of computation of the gain has yet to be clarified.

A business tax of five percent is imposed on the provision of taxable services within the territories of China. Whether the QFII should be subject to this tax depends on whether it has provided “taxable services” in China. From the operating model, the QFII does not need to be in China to effect the buy-sell transaction, so there is a strong argument that business tax shouldn't apply. However, this view continues to be debated. If business tax is not imposed on QFIIs then domestic institutions conducting similar activities might feel they are not competing on a level

playing field. Business tax is equally of concern to investors in QFIIs as it is not creditable in their home country.

The current status

The CSRC, the Ministry of Finance and the SAT continue to work together with representatives from the financial sector to determine and clarify the tax regime for QFIIs. These discussions have seen a frank exchange of views. At one point, the inclination was for a five percent business tax on capital gains. During the most recent meetings opinion turned towards a ten percent withholding tax on interest and gains, but exemption from business tax. It is hoped that the relevant authorities will soon reach a decision on these income tax questions, to minimise the uncertainty that industry and practitioners are facing.

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