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Legal Updates

1. Release of Tax Policy on QFIIs, RQFIIs and Shanghai-Hong Kong Stock Connect Program (Authors: James WANG, Bing XUE, Ying XIA)

In a long-awaited move to provide clarity to the capital gains tax for QFIIs and RQFIIs, the PRC Ministry of Finance, State Administration of Taxation and China Securities Regulatory Commission jointly released the *Circular on Issues Relating to Temporary Exemption of Enterprise Income Tax*("**EIT**")*on Gains from Transfer of Equity Investment Assets Obtained within China by QFIIs and RQFIIs*(Caishui [2014] No. 79, "**Circular 79**")[1]along with the *Circular on Issues Relating to the Tax Policy of the Pilot Inter-connected Mechanism for Trading on the Shanghai and Hong Kong Stock Markets* (Caishui [2014] No. 81, "**Circular 81**")[2] on November 14, 2014.Circular 79 and Circular 81 will become effective on November 17, 2014 when the Inter-connected Mechanism for Trading on the Shanghai Stock Market and the Hong Kong Stock Market ("**Shanghai-Hong Kong Stock Connect Program**") is officially launched.

Tax Policy for Income Tax on Capital Gains Derived by QFIIs and RQFIIs

Since the beginning of the PRC qualified foreign institutional investors ("**QFIIs**") regime in 2002,the PRC tax policy relating to the taxation of income from the transfer of equity investment assets ("**Capital Gains**") derived by QFIIs has been unclear. The capital gains tax for RMB Qualified Foreign Institutional Investors ("**RQFIIs**") program launched at the end of 2011 has similarly remained uncertain.

Circular 79 clarified the tax policy relating to the income tax of Capital Gains derived by QFIIs and RQFIIs.

(1) Temporary exemption of EIT: EIT will be temporarily exempt on income from the transfer of equity investment assets derived by QFIIs and RQFIIs within China on or after November 17, 2014.

(2) Temporal application of aforementioned exemption: Capital Gains derived by QFIIs and RQFIIs prior to November 17, 2014 should pay EIT according to law.

(3) Scope of aforementioned exemption: Circular 79 explicitly provides that the scope of the exemption is limited to QFIIs and RQFIIs that do not have an establishment or office in China, or that have an establishment or office in China but whose income is not connected with such establishment or office.

[1]For the full text of Circular 79, please refer to: http://www.chinatax.gov.cn/n810341/n810755/c1305363/content.html.
[2]For the full text of Circular 81, please refer to: http://www.chinatax.gov.cn/n810341/n810755/c1305421/content.html.

Given that Circular 79 takes the segmentation approach on the temporary exemption of EIT, which may pose a challenge to the potential tax adjustment on the profits previously distributed to foreign investors by QFIIs and RQFIIs, we suggest that QFIIs and RQFIIs confirm with the competent tax authority as soon as possible.

General Analysis of Tax Policy of Shanghai-Hong Kong Stock Connect Program

Regarding the tax policy relating to investments in shares listed on the Stock Exchange of Hong Kong Limited ("**HKEX**")conducted by mainland investors through Shanghai-Hong Kong Stock Connect Program and the investments in A-shares listed on the Shanghai Stock Exchange ("**SSE**") conducted by Hong Kong investors through Shanghai-Hong Kong Stock Connect Program, Circular 81 has made a systematic stipulation.

(1) Comparison of income tax policy for Shanghai-Hong Kong Stock Connect Program

Investor	Type of Income	Income Tax Policy	Note
Mainland Personal	Income arising from price difference of the transfer of shares listed on the HKEX	Individual income tax ("**IIT**") is exempt from November 17, 2014 through November 16, 2017.	
	Dividends arising from investments in shares listed on the HKEX (including dividends arising from the investments in the shares listed on the HKEX by mainland securities investment funds through Shanghai-Hong Kong Stock Connect Program)	Dividends of H-shares: H-shares companies should be liable to the 20% withholding IIT. Dividends of non H-shares: China Securities Depository and Clearing Co., Ltd. ("**CSDCC**") should be liable to the 20% withholding IIT.	H-shares companies shall submit applications to CSDCC for the mainland individual investors' booklet provided by CSDCC. Where withholding tax has been paid overseas, the individual investors may apply for a tax credit to the competent tax authority of CSDCC on the strength of valid evidence of such withholding tax.
Mainland Enterprise	Income arising from price difference of the transfer of shares listed on the HKEX	Income shall be counted as part of total taxable income to which EIT shall be applied according to law.	

	Dividends arising from the investments in shares listed on the HKEX	Dividends shall be counted as part of total taxable income to which EIT shall be applied according to law.	Where the mainland resident enterprise holds the H-shares continuously for more than 12 months, dividends arising from H-shares are exempt from EIT. H-share companies should not be liable to the withholding income tax on dividends. Instead, the mainland enterprise shall pay the tax itself. Where the income tax on dividends has been withheld by non H-share companies listed on the HKEX, the mainland enterprise may apply fora tax credit in accordance with law.
Hong Kong Investors (including enterprise and personal)	Income arising from price difference of the transfer of A-shares listed on the SSE	Income tax is temporarily exempt.	
	Dividends arising from the investments in A-shares listed on the SSE	Before Hong Kong Securities Clearing Company Limited. ("**HKSCC**") can provide the detailed information (such as the identity of the investor, the holding period, etc.) to CSDCC, the listed companies should be liable to the 10% withholding income tax and make the withholding declaration to the competent tax authority.	Where the Hong Kong investor is a tax resident of another country and the tax treaty entered into between such other country and China provides for an income tax rate on dividends lower than 10%, the enterprise or the individual may directly or through the withholding obligor to apply to the competent tax authority for treaty benefit. After the examination and approval of the competent tax authority, the difference between the amount of tax paid and the amount calculated on the rate provided in the tax treaty should be refunded.

(2) Tax policy of business tax on stock trading through Shanghai-Hong Kong Stock Connect Program

Business tax is temporally exempt on income arising from the price difference of trading A-shares listed on the SSE derived by Hong Kong investors (including entity and individual) through the Shanghai-Hong Kong Stock Connect Program.

Business tax is temporally exempt on income arising from the price difference of trading shares listed on the HKEX derived by mainland individual investors through the Shanghai-Hong Kong Stock Connect Program.

Business tax is exempt on income arising from the price difference of trading shares listed on the HKEX derived by mainland entity investors through the Shanghai-Hong Kong Stock Connect Program.

(3) The tax policy of the stamp duty on stock trading through Shanghai-Hong Kong Stock Connect Program

CSDCC and HKSCC may collect stamp duty on stock trading for each other.

Where Hong Kong investors trade, inherit and gift A-shares listed on the SSE through the Shanghai-Hong Kong Stock Connect Program, the stamp duty on security (stock) trading shall be paid according to currently effective mainland tax laws and regulations.

Where mainland investors trade, inherit and gift shares listed on the HKEX through the Shanghai-Hong Kong Stock Connect Program, the stamp duty shall be paid according to currently effective Hong Kong tax laws and regulations.

The release and implementation of the tax policy on QFIIs, RQFIIs and the Shanghai-Hong Kong Stock Connect Program is a significant milestone for the opening-up of China's capital market. We will continue to closely observe and study issues during the implementation of the relevant rules and share with you our latest viewpoints in a timely manner.

2. General Overview of the Catalogue for Guidance on Foreign Investment Industries (Revised Draft for Comments) (Authors: Wenyu JIN, Fanglu LIN, Wenjin ZHANG)

On November 4th, 2014, the National Development and Reform Commission ("**NDRC**") promulgated the *Catalogue for Guidance on Foreign Investment Industries (Revised Draft for Comments)* (the "**Revised Draft**") and released it for public comments. The aims of the Revised Draft are as follows: i) relax market access for foreign investors; ii) change the administration of foreign investment, iii) reduce the number of industries restricted to foreign investment to adjust and optimize the country's economy and iv) relaxing foreign capital percentage limitations in certain industries. Below is a brief summary of the important amendments in the Revised Draft, along with a comparison of the Revised Draft with the currently effective *Catalogue for Guidance on Foreign Investment Industries (Revised in 2011)* (the "**Current Catalogue**").

The Revised Draft Increases The Number of Encouraged Foreign Investment Industries

In addition to preserving the list of encouraged foreign investment industries in the Current Catalogue, the Revised Draft adds new items to the list, namely the "development and application of unique Internet technology", "elderly-care institutions", "industrial design, architectural design, costume design and other creative industries", and others to the *Catalogue of Encouraged Foreign Investment Industries* (the "**Encouraged Catalogue**"). The Revised Draft removed "grid construction and operation" from the Catalogue of Restricted Foreign Investment Industries (the "**Restricted Catalogue**") to the Encouraged Catalogue to meet industrial development demands.

The Revised Draft Reduces the Number of Restricted Foreign Investment Industries

In an unprecedented move, the Revised Draft reduces the number of the restricted foreign investment industries from 79 to 35. Doing so removes restrictions on foreign access in certain industries. The most noteworthy modifications are below.

(1) Removing restrictions on foreign investment in industries relating to the "printing of publications" and the "distribution of audio and video products";

(2) Removing restrictions on foreign investment in the "direct sales, mail order, and internet marketing" industries;

(3) Removing restrictions on foreign investment in the real estate industry "including the development of tracts of land, the construction and operation of high-grade hotels, high-end office buildings, and international exhibition centers, secondary market transactions in real estate, and real estate intermediary or brokerage companies)";

(4) Removing restrictions on foreign investment in "financial companies, trust companies, currency brokerage companies, and insurance brokerage companies"; and

(5) Removing restrictions on foreign investment in industries relating to "photography services", "the construction and operation of cinemas", "the construction and operation of large theme parks", "performance brokerage agencies", and "the operation of recreation places".

The Revised Draft Relaxes Foreign Capital Percentage Limitations in Certain Industries

The Revised Draft significantly reduces, from 43 to 11, the number of the industries where foreign investors are only allowed to operate via a sino-foreign equity joint venture, a sino-foreign cooperative joint venture and/or a partnership venture. The Revised Draft also significantly reduces, from 44 to 22, the number of the industries where foreign investors are allowed to operate, but only if Chinese parties are controlling shareholders. In addition, the Revised Draft further sets forth the qualification requirements for foreign investment in banks and securities companies. The most noteworthy modifications are below.

(1) Removing foreign capital percentage limitations in the E-commerce industry.

Under the Current Catalogue, foreign capital in value-added telecommunications services cannot exceed 50%. The Revised Draft explicitly stipulates that E-commerce is no longer subject to such limitation.

(2) Removing a portion of items in the transportation equipment and electrical machinery manufacturing industries from the Restricted Catalogue, which foreign investors could previously access only through sino-foreign equity joint ventures or sino-foreign cooperative joint ventures, or where Chinese parties had to be the controlling shareholders.

As further examples, foreign investment in industries relating to “the design and manufacturing of air-borne equipment for civil airplanes”, “the design and manufacturing of yachts”, “the manufacturing of power transmitting and transforming equipment”, and others, are no longer required to be made only in the form of sino-foreign equity joint ventures or sino-foreign cooperative joint ventures. Foreign investment in industries relating to “the construction and operation of urban subways and light rails”, “the operation of performances venues”, and others, are no longer subject to the requirement that the controlling shareholders have to be Chinese parties.

(3) Increasing the foreign capital percentage limitation in securities companies.

Under the Current Catalogue the percentage of foreign capital in securities companies cannot exceed one-third. The Revised Draft increases this limitation from one-third to 49%. The Revised Draft further sets forth foreign capital percentage limitations in banks, namely that i) a single overseas financial institution, as a sponsor or as a strategic investor, along with its controlled or joint-controlled affiliates, shall not hold more than 20% of the shares in a single Chinese-funded commercial bank, ii) multiple overseas financial institutions, as sponsors or as strategic investors, along with their controlled or joint-controlled affiliates, shall not hold more than 25% of the shares in a single Chinese-funded commercial bank, iii) amongst all overseas financial institutions, only banking financial institutions can invest in Chinese rural commercial banks.

The Revised Draft Increases and Adjusts Industries Where Foreign Investment is Restricted or Prohibited

While the Revised Draft expands market access for foreign investors by significantly increasing the number of encouraged foreign investment industries, reducing the number of restricted foreign investment industries, and relaxing foreign capital percentage limitations in certain industries, it also places certain newly-emerging industries into the Restricted Catalogue or the *Catalogue of*

Prohibited Foreign Investment Industries (the “**Prohibited Catalogue**”), and moves certain formerly prohibited industries to the restricted category, and formerly restricted industries to the prohibited category. The most noteworthy modifications are below.

(1) The Revised Draft move the “manufacturing of audio and video products and electronic publications” industry from the Prohibited Catalogue to the Restricted Catalogue, requiring Chinese parties to be the controlling shareholders. The “publication of audio and video products and electronic publications” industry still remains prohibited.

(2) The Revised Draft moves “legal consultancy” from the Restricted Catalogue to the Prohibited Catalogue, and modifies the phrasing of the industry to “PRC legal affairs consultancy”.

(3) The Current Catalogue places the “wholesale, retail, and distribution of tobacco” into the Prohibited Catalogue. The Revised Draft places the “wholesale and retail of tobacco leaf, cigarettes, redried tobacco leaf, and other tobacco products” into the Restricted Catalogue.

(4) The Revised Draft moves the “higher education institutions” industry from the Encouraged Catalogue to the Restricted Catalogue, while adding the “foster education institutions” industry to the Restricted Catalogue. According to the Revised Draft, foreign investment in these two industries is now limited to sino-foreign cooperative joint ventures that are controlled by Chinese parties. The Revised Draft also adds “medical institutions” to the Restricted Catalogue. Foreign investment in medical institutions is now limited to sino-foreign cooperative joint ventures.

(5) The Revised Draft places industries relating to “Internet publishing services” and “heritage auction enterprises and heritage stores” into the Prohibited Catalogue.

It should be noted that the Revised Draft has only been released for comments, meaning it still may be further modified and will be finalized by the NDRC. The Revised Draft predictably provides foreign investors with greater access to the China market to optimize the allocation of international and domestic resources for China. We will keep track of further modifications or updates to the Revised Draft, as well as its formal promulgation into law. We will also timely share with you the latest trends in China’s policies towards foreign investment.

Important Announcement

This Newsletter has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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