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## Asset Management • Tax Law

# Capital Gains Tax for QFIIs on the Horizon

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China's tax regulator may start levying a 10 percent enterprise income tax ("**EIT**") on capital gains derived from the disposition of securities investments in China by qualified foreign institutional investors ("**QFIIs**"), according to an official of the China Securities Regulatory Commission ("**CSRC**") as quoted by several local media sources.

### Current Tax Regime for QFIIs

QFIIs are foreign institutional investors approved by the CSRC to invest in the securities market in China. China's QFII program was first introduced in 2002. Two major tax circulars[1] were thereafter issued that specifically apply to QFIIs and set out the current tax regime as follows:

- Business Tax: Capital gains derived from the price difference in the disposing of securities in China are exempt from business tax.
- Enterprise Income Tax: Dividends, bonuses and interest income derived from China are taxable to the EIT at the rate of 10 percent on a withholding basis. QFIIs may apply to benefit from preferential tax treatments under applicable tax treaties where such treaties provide for a lower EIT rate;

However, current PRC tax laws and regulations are silent on the EIT treatment of capital gains derived by QFIIs from China. Pursuant to the *PRC Enterprise Income Tax Law*, foreign investors without a permanent establishment in China should be subject to the EIT at the rate of 10 percent on their China-sourced capital gains, unless such tax is exempt under applicable tax treaties. Theoretically, QFIIs (often without a permanent establishment in China) should

[1] *Notice on the Business Tax Policies for Qualified Foreign Institutional Investors*, jointly promulgated by the Ministry of Finance and the State Administration of Taxation and effective as of December 1, 2005, and *Notice on Issues Concerning the Withholding of Enterprise Income Tax on Dividends, Bonuses and Interests Paid to QFII by Chinese Resident Enterprises*, promulgated by the State Administration of Taxation and effective as of January 23, 2009.

be subject to the 10 percent EIT for capital gains arising from the sale of their securities investment in China. This being said, practical tax issues, such as the tax assessment periods and tax payment methods for such tax are rather unclear. In addition, foreign investors were historically exempt from the EIT on capital gains generated from the disposing of B shares and stocks of Chinese companies listed overseas. As a result, in practice, local tax authorities virtually had never attempted to tax the capital gains of QFII's until the Lehman Brothers case.

**The Lehman Brothers Case**

The European branch of Lehman Brothers had been a licensed QFII since 2004. Lehman Brothers entered into insolvency proceedings in 2008, and all its overseas assets were liquidated, including the QFII's securities investments in China. In late 2010, the State Tax Bureau of Beijing Haidian District assessed the capital gains of the Lehman Brothers' QFII to be around RMB 3.99 billion (presumably, the accumulated capital gains since the inception of the QFII) and levied an EIT of around RMB 399 million on such gains. Upon paying the taxes, the QFII was allowed to repatriate its funds outside of China.

Although the Lehman Brothers case is viewed by some people to be a precedent for taxing the capital gains of QFIIs, it may only provide limited guidance for EIT treatment on the capital gains of other QFIIs. In the Lehman Brothers' case, the EIT on capital gains was only assessed upon liquidation of the QFII. Furthermore, the tax payment was also a necessary condition to effect the foreign exchange payment of the liquidated proceeds (i.e., a tax payment certificate is required for making the relevant foreign exchange payments in an amount more than USD 30,000).

**The Expected New Tax Policy**

According to the CSRC official as cited in the above mentioned news report, the possible new tax policy may provide for the imposition of the 10 percent EIT on the annual net capital gains of QFIIs after offsetting against losses. Both the QFII's self-owned funds and clients' entrusted funds in the QFII's account would be subject to such tax. The new tax policy is not expected to affect the existing tax treatment on the capital gains of PRC taxpayers (e.g., income tax is currently exempt on income from the disposition of publicly traded stocks and open-ended funds by PRC individual taxpayers).

Additional details of the possible new tax policy are still unavailable. Nevertheless, we expect the new tax policy to clarify the following issues:

- Tax assessment period: EIT on capital gains of foreign investors is in principle assessed on a payment-by-payment basis. This is apparently not practical for QFIIs. It seems that the new tax policy will provide for tax assessment on an annual basis, allowing the offsetting of the capital loss of one transaction from the capital gain of another transaction. The details regarding the provisions remain to be seen.

- Carry-forward of capital losses: Whether unused capital losses (i.e., capital losses after offsetting capital gains) can be carried forward and for how long may such capital losses be carried forward is expected to be clarified in the new tax policy.

- Application of tax treaties: Certain tax treaties concluded by China may exempt capital gains on the disposition of shares derived by foreign investors from being taxed in China. Whether the tax treaty treatment may apply to QFIIs is to be clarified in the new tax policy.

- Tax payment method: The new tax policy is also expected to specify whether the EIT on capital gains is to be withheld by the relevant Chinese stock exchange or an entrusted Chinese company or filed and paid by the QFII directly.

- Effective date of the new policy: Whether the new tax policy will retroactively apply to capital gains accumulated before the implementation of the new policy is another major concern of QFIIs. Due to the lack of clear tax rules, certain QFIIs may not have made any tax provisions in relation to the EIT on capital gains. Relevant financial arrangements may have to be carried out in anticipation of the EIT on capital gains.

The new tax policy, if issued, will clarify the EIT treatment on capital gains for QFIIs. It will also facilitate the foreign exchange procedures for repatriating QFII's investment proceeds outside of China. On the other hand, the tax burden may also affect the investment returns of QFIIs and should thus be carefully analyzed and assessed.

## Important Announcement

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