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New Tax Regime Coming for Qualified Foreign Institutional Investors in China

Since its launch in 2002, the Qualified Foreign Institutional Investor (“QFII”) program has been the principal means for foreign investors to invest directly in the securities markets of Mainland China. However, uncertainty regarding the application of China’s tax laws to QFIIs and their investments has complicated QFII operations and potentially discouraged prospective entrants to the market.

Recently, it has been reported that the China Securities Regulatory Commission (“CSRC”), China’s primary securities regulator, and the State Administration of Taxation have reached an agreement regarding the application of China’s income tax laws to QFIIs that will enlarge the basis of assessing income tax on QFIIs. However, the final details of the agreement have not yet been published, so foreign investors must wait for greater clarity while currently factoring the anticipated changes into their plans.

Taxation of QFIIs

Currently, investments in China’s securities markets through the QFII program are subject to a 10% income tax imposed on dividends, bonuses and interest generated from securities investments. Domestic investors are not subject to this tax, although domestic financial institutions are subject to a 5% business tax that is not levied on QFIIs.

Recent media and government reports indicate that the basis of the 10% income tax to which QFIIs are subject soon will expand to include gains from securities transactions. It is anticipated that this increase in the basis of income tax will be imposed on QFIIs only - domestic investors will continue to not be subject to this tax. Specifically, this new income tax will apply to the proprietary funds of QFIIs and QFII client assets, although “China Open-End Funds”[1] are reported to be exempt from this income tax.

Details of the new tax policy, such as calculation methods and timelines, scope of imposition, ability to offset losses, potential retroactivity, and grandfathering periods, are expected to be released at a later date.

Potential Impact of Tax Changes

This disparate, and less favorable, treatment of foreign investors in China may at the margins discourage foreign investors from investing in China’s securities markets. It also is likely to trigger discussions between foreign and Chinese regulators on the topics of reciprocity and protectionism. However, by enlarging the basis of taxation on investments by QFIIs, Chinese authorities may be signaling their belief that China’s securities markets are maturing and sufficiently attractive to foreign investors to support increasing tax revenues from foreign investment while still being able to expand foreign investor participation in China’s securities markets[2]. Moreover, given the relatively small percentage of the China A-share market represented by QFII investments, the change of tax basis is unlikely to significantly impact the broader China A-share market.

This change may create uncertainty for financial services companies who are considering or are in the process of applying for QFII licenses, at least until more details regarding the change are available. Given the lack of definitive information currently available, it is difficult to assess the impact of this new tax on the disclosures required as part of the license application process or the regulatory processing of applications.

On a more positive note, once implemented, this new tax is likely to clarify the situation of QFIIs in China. To this point, QFIIs have encountered practical difficulties in calculating performance and profitability of China A-share investments and repatriating their profits outside of China due to the lack of clear taxation rules on gains from securities trades. Additionally, this new taxation regime will increase the predictability for QFIIs and their clients at the time of investment regarding the appropriate accrual and accounting for applicable taxes at exit. Due to the uncertainty to date, QFIIs have taken inconsistent positions regarding the need to set aside funds for purposes of tax payment. Finally, greater clarity and transparency should decrease potential legal risks associated with QFII investment in China.

We will provide further updates as more information becomes available.

Footnotes

[1] Under the QFII program rules, China Open-End Funds are defined as open-end securities investment funds raised through public offerings outside of China, with at least 70% or more of their assets invested in China's securities markets.

[2] For a discussion of recent changes to the QFII regime, including the significant increase in the investment quota available to QFIIs, please refer to OnPoint, China Updates Qualified Foreign Institutional Investor Rules and Encourages Additional Foreign Investment in China (October 5, 2012).

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