

# Tax Analysis

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## PRC Tax

# Global Financial Services Industry

## Recent Developments on Taxation of QFIIs in China

### Background

The Chinese taxation of qualified foreign institutional investors (QFIIs) has always been a concern to practitioners. At issue, in particular, is whether capital gains derived by QFIIs should be taxed in China and if so, how such gains should be taxed.

According to current tax regulations and practice, capital gains derived by QFIIs in China are exempt from Business Tax (BT). The Enterprise Income Tax (EIT) implications, however, are not as clear since the QFII scheme was first introduced at the end of 2002.

Under the Foreign Enterprise Income Tax (FEIT) regime that applied until 2008, capital gains derived by a foreign investor without an establishment in China from the sale of an equity interest in a Chinese enterprise were subject to a 10% withholding tax under domestic law unless such gains were exempt under an applicable double taxation agreement (DTA). By contrast, gains derived by a foreign investor (without an establishment in China) from the sale of B-shares or overseas-listed shares of a Chinese enterprise (e.g. H-shares) were exempt from FEIT.

Since the introduction of the unified EIT law as from 1 January 2008, nonresidents (without an establishment in China) deriving China-source capital gains are taxed at 10% unless such income is exempt under an applicable DTA. Since QFIIs that do not have an establishment in China generally would be viewed as nonresident taxpayers, technically speaking, capital gains derived from the sale of their investments should be subject to the 10% withholding tax.

In practice, however, the tax filing method/procedure is not clear and we have not seen any local tax authorities have ever attempted to collect withholding tax on capital gains from QFIIs. Therefore, most QFIIs have struggled with whether or not to recognize a PRC tax provision on capital gains, and if not, what measures could be adopted to protect themselves against tax exposure if the PRC tax authorities decide to collect the tax in the future.

### Lehman Brothers' QFII

The tax treatment of capital gains recently became somewhat clearer when one of the largest QFIIs was subject to withholding tax upon the repatriation of its investment proceeds from China.

At the end of 2010, the Beijing State Tax Bureau collected about RMB 399 million in income tax from the European branch of Lehman Brothers, where it had held a QFII license in China since 6 July 2004. According to news reports, tax was imposed on the capital gains derived by the QFII in the amount of RMB 3.99 billion when the QFII had finally received approval to liquidate and remit all of its funds out of China. Although the news reports did not disclose whether the gains had accumulated since the QFII license was granted, or how the taxable gains were determined, it is likely that the capital gains realized by the QFII since its inception were subject to PRC income tax without any exemption. Based on this news, it seems clear that a QFII will be subject to PRC income tax on capital gains.

#### Unanswered questions

Although the Chinese tax authorities have successfully collected capital gains tax on gains derived by a QFII, there are still many uncertainties as to how this single incident would apply to other QFIIs, in particular, the following:

- How income tax on capital gains will be determined and collected, including whether collection will be on a periodic basis (i.e. annually), when profits are repatriated or when a QFII is liquidated;
- Whether capital gains realized before 2008 will be exempt from FEIT;
- Whether losses can be used to offset gains; and
- Whether DTA relief will apply to QFIIs (i.e. to the QFII itself or whether a look-through approach will be taken).

Based on our discussions with the State Administration of Taxation (SAT), we understand that implementation rules on the income tax treatment of capital gains derived by QFIIs could be issued in the near future, and the rules may be applied on a retroactive basis.

We will continue to monitor developments and communicate with the SAT and share the latest news with you.

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