Chinese Tax Authorities will recently commence tax cleaning-up activities targeting incomes of QFIIs/RQFIIs

By King & Wood Mallesons on March 24, 2015 Posted in Tax

By King & Wood Mallesons' Tax Group

On 31st October, 2014, the Ministry of Finance, State Administration of Taxation (SAT) and China Securities Regulatory Commission jointly published Cai Shui [2014] No.79 (Circular 79) to clarify enterprise income tax (EIT) policy for capital gains with respect to QFIIs/RQFII. Under Circular 79, QFIIs/RQFIIs are temporarily exempt from EIT on China-sourced capital gains derived from transfer of equity investment assets (including shares) effective from 17th November, 2014. However, at the same time, it provides that the abovementioned capital gains derived prior to 17th November, 2014 shall be subject to Chinese EIT.

On 26th February, 2015, a meeting regarding QFIIs/RQFIIs tax regime was held in Beijing by Asset Management Association of China. According to information delivered in the meeting, recently tax authorities in Beijing, Shanghai and Shenzhen would commence tax cleaning-up activities specifically targeting incomes derived by QFIIs/RQFIIs during the period from 17th November, 2009 to 16th November, 2014. The following is the scope covered by the activities.

The covered incomes include China-sourced dividends, interests and capital gains regarding transfer of equity investment assets derived by QFIIs/RQFIIs. Accordingly, transfer of investment asset in debt nature, including transfer of convertible bonds before conversion, is excluded from the scope of the activities. The meeting especially clarified that all incomes derived from transfer of mixed type of investment assets shall be treated as incomes derived from transfer of equity investment assets; the same treatment applies to transfer of convertible bonds after conversion.

The covered period begins from the date when QFIIs/RQFIIs were permitted to entry into the Chinese markets till 16th November, 2014, limited to a 5-year period permitt[th] November, 2009 to 16th November, 2014. In other words,

- where QFIIs/RQFIIs were permitted to entry into the Chinese markets prior to 17th November, 2009, the unpaid tax regardingy into the Chinese markets[th] November, 2009 ande un[th] November, 2014, will be collected by tax authorities;

- where QFIIs/RQFIIs were permitted to entry after 17th November, 2009, the unpaid tax regarding incomes derived during the date when QFIIs/RQFIIs were permitted to entry and the date of 16th November, 2014, will be collected.

From the tax administration and collection perspective, where there is no PE of the QFII/RQFII, the capital gain of each transaction shall be subject to withholding EIT at the rate of 10%. Off-setting between losses and profits with respect to different transactions is disallowed. Where the same product was acquired via several transactions, "first-in, first-out method" or "moving weighted average method" are available for calculation of tax basis. Besides, dividends, bonus profits and interest incomes are subject to 10% withholding EIT. Further, relevant institutions or beneficial owners may apply for preferential tax rates as provided in tax treaties. When collecting unpaid EIT, capital gains derived from transfer of equity investment assets are not charged late payment surcharges. As for dividends, bonus profits and interest incomes, such surcharges are imposed at 0.05% of the underpaid tax amount per day.

Our Observation

The tax treatment under Circular 79 clarifies previous doubt in relation to capital gains derived by QFII/RQFII, and the cleaning-up activities alsot to withholding, transfer of investment asset in debt nature, including transfer of convertible tration and collection perspective. However, possibly due to non-official announcement in the meeting, the currently well-known cleaning-up scheme still leaves some uncertain issues which should be clarified. Among others, the most important issues are about collection of unpaid tax and withholding tax obligation.

The covered period for collection of underpaid tax is of 5-year period, i.e. from 17th November, 2009 to 16th November, 2014. We understand that the 5-year term is actually based on Art. 52 of the Tax Administration and Collection Law. However, if taxpayers previously actively communicated with in-charge tax authority requesting to pay tax, while the tax authority clearly expressed that there was no need to pay due to lack of clear tax policy, in such case, it should be considered whether the 3-year period for collection underpaid tax under the same Art. 52 should apply. This issue reminds us that the Tax Administration and Collection is under amendment. It's worth thinking that, in the revision process, how to stipulate the collection period for underpaid tax and to make reasonable use of advance ruling system to reduce uncertainty for taxpayers in relation to tax treatment.

Besides, in the cleaning-up activities, capital gains will not be subject to late payment surcharges. This demonstrates from another perspective, that in circumstance where taxpayers sufficiently disclose transaction to and actively communicate with tax authorities, the treatment for exemption of late payment surcharges is justified. Such treatment provides guidance to similar situations in future, and is consistent with our understanding regarding where the revision of the Tax Administration and Collection Law will go.

Another matter that needs to be clarified is about determination of withholding agents and withholding obligation. For prudent considerations, in practice, custodian banks generally make a provision for 10% withholding tax. However, if the custodian bank failed to make the provision, it is a very important issue that how to determination withholding obligation afterwards under Circular 79 given that underlying payment has been made without withholding due to lack of clear tax rules at that time, especially, from the theoretical point of view, the buyer of underlying shares might be obliged to withhold. It is difficult in answering whether the withholding obligation and relevant punishment on failure to withhold should retroactively apply.

Furthermore, it should be noted that although the meeting clarified that QFIIs/RQFIIs may apply for tax treaty benefit, relevant tax treaties do not apply automatically. Taxpayers or their withholding agents still need to file their applications with the tax authorities to claim such benefits. QFIIs/RQFIIs may apply for tax treaty benefit, relevant tax treaties do not apprtainties in relation to the treaty benefit applications which need to be communicated with the tax authorities in advance：

- The tax residency of QFII or RQFII. In most tax treaties, the registered place or the place of effective management is considered to determine the tax residency. However, unlike traditional business models, some QFIIs or RQFIIs operate in different places other than their registered places, places of management or places of decisions-making. In this regard, there might be additional complexity to determine the tax residency of a QFII or RQFII.

- Choice of applicable tax treaty. Given that the unpaid tax retroactively collected arises in previous years, theoretically, the newly effective treaties (e.g. Ireland, Switzerland, and Netherland etc.) re-signed with China do not apply to the incomes derived prior to their effective days. However, since the tax obligation arises in current period, how relevant treaties apply might be an issue to be further communicated with the tax authorities in advance.

ABOUT US:

Our tax team has extensive experience assisting clients in tax planning, comprehensive tax solution and tax controversy resolution. We have represented clients in lots of projects, including M&A, security market investments, fund investments, banking, IP etc. We have been responsible for negotiation and communication with tax authorities in many complex tax dispute cases. We would be glad to provide one-stop services from both legal and tax perspectives with regards to your business operation or foreign direct investment in China, outbound investment, M&A, re-IPO business model optimization and tax planning, as well as act as your private tax advisor in personal fortune planning. We are also capable of providing creative and practical tax controversy resolution through in-depth legal and tax technical skill in combination with smooth communication with various tax authority in tax area.

CONTACT US:

董刚(Tony Dong)：tony.dong@cn.kwm.com ;

赵炎(Zhao Yan)：yan.zhao@cn.kwm.com ;

叶永青(Bill Ye)：bill.ye@cn.kwm.com ;

段桃(Duan Tao)：duantao@cn.kwm.com 。