

China Tax Alert

Issue 25, November 2018

Three year tax exemption on bond interest for foreign investors

Regulations discussed in this issue:

- Circular Caishui [2018] 108

Background

On 7 November 2018, China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued Circular [2018] 108 (Circular 108). This gives effect to the 30 August 2018 State Council announcement of a 3 year exemption from corporate income tax withholding tax (WHT) and Value Added Tax (VAT) for China-sourced bond interest derived by overseas institutional investors. The WHT and VAT exemptions apply from 7 November 2018 to 6 November 2021.

Circular 108 has a key role to play in enhancing the attractiveness of China's bond market to foreign capital, by limiting the tax leakages that would otherwise reduce their overall return. China is unusual, among countries, in applying VAT to bond interest payments, and the lack of a VAT input credit makes it a real cost; the Circular 108 VAT exemption corrects for this. As regards WHT, various jurisdictions, such as the United States, Japan and Australia, exempt certain corporate bond interest from WHT, so the Circular 108 WHT exemption draws China level.

On the whole, the release of Circular 108 will no doubt be warmly welcomed by overseas institutional investors and is a significant step in opening up the bond market in China.

KPMG observations

KPMG has following specific observations on Circular 108:

Scope of exemption

Over the past 5-10 years, as the China domestic bond market has opened up, the number of foreign investors, and amounts investment by them, have increased considerably. Currently, there are a range of investment channels through which foreign investors may access China capital markets, including:

- The China Inter-Bank Market (“CIBM”);
- Stock exchanges in Shanghai and Shenzhen through the Qualified Foreign Institutional Investors (“QFII”) and RMB Qualified Foreign Institutional Investors (“RQFII”); and
- The CIBM for qualified financial institutions via the Mainland-Hong Kong Bond Connect program.

Against this background, a number of considerations arise in relation to Circular 108:

- Over the years the government has repeatedly announced new investment programs, opening further access channels to foreign investors; Circular 108 does not refer to any of these programs specifically, in setting the scope of exemption. Potentially this means that the exemption on bond interest should be applied to QFII, RQFII, CIBM, Bond Connect programs, and other new programs to be introduced within the 3 year period to 2021.
- There is some uncertainty as to whether the VAT and WHT exemptions may be applied to bond interest arising from debt instruments generally, or only to “bonds” such as government bonds, government support institution bonds, financial bonds, corporate credit bonds. In this regard it should be noted that there are various types of tradable debt instruments available to overseas institutional investors, including treasury bonds, local government bonds, central bank bonds, financial bonds, corporate credit bonds, certificates of deposit, asset-backed securities, etc. Bond interest may be potentially interpreted as interest derived from all the debt instrument available to overseas institutional investors, though there could readily be different interpretations between tax authorities and taxpayers.
- The types of trades which can be carried out by foreign investors include cash trades, repo and etc. In this regard it is noted that Circular 108 provides WHT and VAT exemptions for bond interest derived by overseas institutional investors without referring or limiting it to any specific type of trading activities.

Retroactive impact

The Circular 108 exemptions apply for the period from 7 November 2018 to 6 November 2021 and may not be applied retroactively. For the period preceding the issuance of Circular 108, bond interest income derived by overseas investors is subject to 10% WHT and 6% VAT. The WHT treatment is on the basis that the income is not connected with a China permanent establishment (PE) of the foreign investor.

However, for non-government bonds, there has been a lack of an effective withholding mechanism in respect of certain bond programs which has meant that in many cases it has been difficult (if not impossible) for WHT and VAT to have been withheld.

WHT withholding practices have been different for each type of investment program:

- Take, for example, bonds traded on the Stock Exchange Market through the QFII and RQFII program. China Securities Depository & Clearing Corp. Ltd. Shanghai branch and Shenzhen branch, the clearing houses, have been entrusted by Chinese bond issuers to withhold WHT on their behalf on interest paid to QFII and RQFII investors. The clearing houses then transfer the WHT withheld to the bond issuers who, in turn, remit the WHT to their respective in-charge tax bureaus.
- By contrast, for bonds traded in CIBM and through Bond Connect, there is currently no effective WHT withholding mechanism.

For VAT purposes, Circular Caishui [2016] 36 removed the use of withholding agents (as compared with the prior rules), and therefore there is currently no effective VAT withholding mechanism in place.

As Circular 108 does not clarify the appropriate treatment for the period prior to 7 November 2018, in practice, local tax authorities may follow up on WHT and VAT issues for bond interest income of overseas institutional investors arising before that date. In light of this tax uncertainty, potentially affected firms might be advised to consult with their regular KPMG advisor for assistance.

Circular 108 will clearly be warmly welcomed by overseas institutional investors because it resolves uncertainty and reduces the tax costs for their investments in the domestic bond market. However, Circular 108 cannot be retrospectively applied and the historical tax uncertainty for certain investment programs still remains unchanged. Please consult with your regular KPMG advisor for assistance.



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