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Tax analysis of A-share equity investments through the QFI mechanism and Stock Connect for offshore investors outside the Chinese Mainland

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Currently, the capital market in the Chinese Mainland is not fully open. For offshore investors, they need to invest in the mainland capital market through specified channels. Under the existing connectivity regimes between the Chinese Mainland and Hong Kong SAR, offshore investors are able to invest in mainland financial markets through the Qualified Foreign Institutional Investor (QFI) mechanism, Shanghai-Hong Kong Stock Connect (Stock Connect), Bond Connect and Mutual Recognition of Funds.

In June 2022, the China Securities Regulatory Commission (CSRC) issued the *Announcement on the Inclusion of Exchange Traded Funds (ETFs) into Stock Connect*[1], which allowed investors from the Chinese Mainland and Hong Kong to trade the eligible shares and ETFs listed on each other's exchange through local securities companies or brokers, providing an additional channel for offshore investors to invest in A-shares. In addition to the traditional QFI channel, offshore investors may gain equity exposure in the Chinese Mainland by investing in ETFs through Northbound Stock Connect.

Tax costs directly impact the returns of investors. For offshore investors who invest in A- shares equity assets, the tax implications under different investment channels could vary. In this article we set out the analysis and comparison of the tax costs through the QFI channel and Stock Connect (specifically the Northbound ETFs Investments).

[1] Announcement on the Inclusion of Exchange Traded Funds into Stock Connect (CSRC Announcement [2022] No. 39)

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Overall tax rules

Generally speaking, there are two types of income involved for investments through the QFI mechanism and ETF investments through Stock Connect, i.e. income upon distribution[2] and income upon transfer. Under the prevailing tax system in China, these incomes would generally trigger Value Added Tax ("VAT"), income tax (Individual Income Tax ("IIT") applies to individual investors, while Corporate Income Tax ("CIT") applies to institutional investors) and Stamp Duty ("SD").

VAT

VAT is an indirect tax charged on the value added to the goods and services arising from transactions. On 1 May 2016, China launched VAT reform to all industries. Based on the regulations set out in the *Notice of the Ministry of Finance and the State Administration of Taxation on the Launch of the Pilot Scheme on Levying Value Added Tax in Place of Business Tax*[3] (Cai Shui [2016] No. 36, hereinafter "Circular 36"), entities and individuals engaging in the sale of services/goods, intangible assets or immovables within the territory of the People's Republic of China[4] (hereinafter called "within China") shall be VAT taxpayers.

CIT

CIT is an income tax charged on the business operation income and other income generated by enterprises and other organisations that derive income in/from China. The taxable income of an enterprise shall be the balance amount of total revenue of the enterprise recognised in each tax year less various deductible items and recoverable tax loss incurred in prior years. The taxable revenue mainly includes revenue derived from the sale of goods, service provisions, interest income and investment gains; various deductions include costs, expenses, taxes and losses incurred by an enterprise. Under the PRC CIT framework, PRC tax residents shall pay CIT at the rate of 25% for domestic and overseas income.

Offshore investors, generally non-PRC resident taxpayers under the CIT framework, shall pay CIT for the income derived from China in accordance with the Corporate Income Tax Law of the People's Republic of China.

Where the non-resident enterprise has no establishment or place ("E&P") in China, or the enterprise with E&P in China but the income so derived in China is not effectively connected with their E&P, CIT shall be reported by the non-PRC resident enterprise for income derived from China at the rate of 10%.

IIT

IIT is an income tax charged on various taxable incomes derived by individuals. Similar to CIT, IIT taxpayers include both resident and non-resident taxpayers based on the existence of a domicile and duration of residence. Non-resident individual refers to a taxpayer who does not meet the criteria (conditions) of being a tax resident, and shall bear limited tax obligations, and pay IIT only for income derived from China. As defined in the Individual Income Tax Law of the People's Republic of China, non-resident individuals refer to "individuals who neither have a domicile nor reside in China, or individuals who do not have a domicile in China but reside in China for less than 183 days cumulatively within a tax year".

SD

In accordance with the Stamp Duty Law of the People's Republic of China, entities and individuals who conclude taxable documents and conduct securities transactions within China shall be taxpayers of stamp duty. According to Stamp Duty Law, "securities transactions" refer to the transfer of stocks and stock-based depository receipts traded on the stock exchanges. The stamp duty for a securities trade is levied on the transferor of securities instead of the transferee. The stamp duty payable amount shall be calculated based on dutiable document amount multiplied by an applicable stamp duty rate.

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[2] Income upon distribution mentioned herein refers to the Chinese Mainland sourced dividends and other income during holding of A-shares equity assets.

[3] Notice of the Ministry of Finance and the State Administration of Taxation on the Launch of the Pilot Scheme on Levying Value-added Tax in Place of Business Tax (Cai Shui [2016] No. 36)

[4] As defined in the current tax law, the "territory of the People' s Republic of China" shall refer to the Chinese Mainland only, and exclude Hong Kong SAR, Macao SAR and Taiwan.

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Tax costs arising from investments through Stock Connect and QFI

Under the prevailing tax regimes in China, Chinese tax authorities issued multiple tax rules and regulations regarding the above-mentioned investment channels. The analysis and comparison of China tax costs arising from investments in the A-shares equity market through the Northbound Stock Connect and QFI mechanism are set out as follows.

<table>
<tr><th rowspan="2">Tax type</th><th colspan="2">Distribution income</th><th colspan="2">Transfer income</th><th rowspan="2">Applicable tax rule</th></tr>
<tr><th>Stock Connect</th><th>QFI</th><th>Stock Connect</th><th>QFI</th></tr>
<tr><td>VAT</td><td>Non-taxable</td><td>Non-taxable</td><td>Exempt</td><td>Exempt</td><td>Cai Shui [2016] No. 36</td></tr>
<tr><td>CIT</td><td rowspan="2">Dividends income at 10%</td><td>Dividends income at 10%</td><td rowspan="2">Temporarily exempted on capital gains derived from transfer</td><td>Temporarily exempted on capital gains from transfer of equity assets</td><td rowspan="2">Guo Shui Han [2009] No. 47
Cai Shui [2014] No. 79
Cai Shui [2015] No. 125
Ministry of Finance, State Administration of Taxation and CSRC Announcement [2022] No. 24</td></tr>
<tr><td>IIT</td><td>N/A</td><td>N/A</td></tr>
<tr><td>SD</td><td>Non-taxable</td><td>Non-taxable</td><td>Non-taxable</td><td>1‰ on transaction proceeds</td><td>Stamp Duty Law of the People's Republic of China</td></tr>
</table>

Note: The above tax analysis and comparison are based on the assumptions that (1) the offshore investor is not a PRC tax resident, and has no E&P in China or has E&P in China but the income so derived in China is not effectively connected with their E&P; (2) preferential treatment of tax treaties/agreement signed between China and other jurisdictions are not considered; (3) The categorisation of distribution income arising from investment through Stock Connect or QFI is not dependent on the nature of investment (i.e. capital preservation).

Note that in practice, as the tax treatment for the direct investment in ETFs through QFI has not been clarified under the prevailing tax regulations, investors should carefully analyse and assess the tax impact before making any investment decisions.

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The relevant rules on the above-mentioned tax treatments are summmarised as follows.

01 VAT

Upon distribution

As set out in Circular 36, if the income derived by the investor upon distribution does not fall within the definition of loan services, the distribution income derived during the investment holding period shall not be subject to VAT.

Upon transfer

- Pursuant to Circular 36, the transfer of financial products shall be subject to VAT.
- Pursuant to Article 1.22 of *Appendix 3 of Circular 36 - Provision on the Transitional Policies Concerning the Pilot Scheme on Levying Value-added Tax in Place of Business Tax*, the following financial products transfer income shall be VAT exempted: "Qualified Foreign Institutional Investors (QFII) entrusting a domestic company to engage in securities trading in China", "Trading of Chinese Mainland fund units by Hong Kong market investors (including enterprises and individuals) through mutual recognition of funds" and "Transfer of financial products by individuals".

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02 Income Tax

In respect of income tax, the investors shall be categorised as taxpayers who are subject to IIT (e.g. individual investors who trade via Stock Connect) and taxpayers who are subject to CIT (e.g. institutional investors).

2.1 CIT

Upon distribution

- Pursuant to Article 1 and 2 of the *Notice from the State Administration of Taxation on Relevant Issues Regarding the Withholding of Corporate Income Tax on Dividends and Interests Paid by PRC Resident Enterprises to QFII*[5] (Guo Shui Han [2009] No. 47), dividends and interests income derived by QFII from China shall be subject to CIT at the rate of 10% according to the Corporate Income Tax Law. In respect of dividends, the payer of the dividends shall be responsible for withholding CIT; in respect of interests, the CIT shall be withheld by the enterprise at the time when the interest payment is made or becomes due. In addition, where a QFII is entitled to tax treaty benefits, relevant application could be submitted to the in-charge tax authority, and the tax authority shall assess the eligibility of enjoying benefits in accordance with the applicable tax treaty after the application is reviewed; Where a tax refund is concerned, it shall be processed in a timely manner. However, for other types of distribution income, e.g. fund distribution income, though the *Notice of Ministry of Finance and State Administration of Taxation on Corporate Income Tax Incentive Policies*[6] (Cai Shui [2008] No. 1) sets out that income derived by investors from distributions of securities investment funds shall be temporarily exempted from CIT, whether this provision could also apply to the fund distribution income of QFI is yet to be clarified.

- Pursuant to Article 1 of *Announcement on Issues Concerning Tax Policies Applicable upon the Inclusion of Exchange-traded Funds into the Chinese Mainland-Hong Kong Stock Connect*[7] (Ministry of Finance, State Administration of Taxation and CSRC Announcement [2022] No. 24, hereinafter called "Announcement No. 24"), upon the inclusion of ETFs into Chinese Mainland-Hong Kong Stock Connect, the existing tax policies related to the mutual recognition of funds between the Chinese Mainland and Hong Kong SAR shall apply.

[5] Notice from the State Administration of Taxation on Relevant Issues Regarding the Withholding of Corporate Income Tax on Dividends and Interests Paid by Chinese Resident Enterprises to QFII (Guo Shui Han [2009] No. 47)

[6] Notice of Ministry of Finance and State Administration of Taxation on Corporate Income Tax Incentive Policies (Cai Shui [2008] No. 1)

[7] Announcement on Issues Concerning Tax Policies Applicable upon the Inclusion of Exchange-traded Funds into the Chinese Mainland-Hong Kong Stock Connect (Ministry of Finance, State Administration of Taxation and CSRC Announcement [2022] No. 24)

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Pursuant to Article 2.2 of the *Notice of Ministry of Finance and State Taxation Administration on Tax Policies Relating to Mutual Recognition of Funds between Chinese Mainland and Hong Kong SAR*[8] (Cai Shui [2015] No. 125, hereinafter called "Circular 125"), income derived by a Hong Kong market investor (including enterprise and individual) from a Chinese Mainland fund through mutual recognition of funds shall be subject to the withholding income tax at 10%, which shall be withheld by the Chinese Mainland listed company upon its distribution of dividends to the said Chinese Mainland fund.

Upon transfer

- Pursuant to the *Notice of Ministry of Finance, State Taxation Administration and CSRC on the Temporary Exemption of Corporate Income Tax on Incomes derived by QFII and RQFII from Transfer of Shares and Other Equity Assets within China*[9] (Cai Shui [2014] No. 79), effective from 17 November 2014, income derived by QFII from the transfer of shares and other equity assets within China is temporarily exempted from CIT. The income derived by QFII from the transfer of shares and other equity assets within China prior to 17 November 2014 shall be subject to CIT. The notice applies to QFII without an E&P, or with E&P in China but the income so derived in China is not effectively connected with their E&P. In respect of the transfer of other non-equity assets, as the PRC tax rules and regulations have not provided specific rules, the tax treatment shall be determined based on review and analysis on a case-by-case basis.
- Pursuant to Article 2.1 of Circular 125, income derived from the transfer of Chinese Mainland fund holdings by Hong Kong market investors (including enterprises and individuals) through mutual recognition of funds shall be temporarily exempted from income tax.

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[8] Notice of Ministry of Finance and State Taxation Administration on Tax Policies Relating to Mutual Recognition of Funds between Chinese Mainland and Hong Kong SAR (Cai Shui [2015] No. 125)

[9] Notice of Ministry of Finance, State Taxation Administration and CSRC on the Temporary Exemption of Corporate Income Tax on Proceeds derived by QFII and RQFII from Transfer of Shares and Other Equity Assets within China (Cai Shui [2014] No. 79)

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2.2 Individual Income Tax

Upon distribution

- As QFII does not involve an individual investor, individual income tax shall not apply.
- In respect of Stock Connect, pursuant to Article 2.2 of Circular 125, distribution income derived by a Hong Kong market investor (including enterprise and individual) from a Chinese Mainland fund through mutual recognition of funds shall be subject to the withholding income tax at 10% tax rate, which is withheld by the Chinese Mainland listed company upon its distribution of dividends to the said Chinese Mainland fund.

Upon transfer

- As QFII does not involve an individual investor, individual income tax shall not apply.
- Pursuant to Article 2.1 of Circular 125, income derived from the transfer of Chinese Mainland fund holdings by Hong Kong market investors (including enterprises and individuals) through mutual recognition of funds shall be temporarily exempted from income tax.

03 Stamp Duty

Upon distribution

Entities and individuals who conclude taxable documents and conduct securities transactions within China shall pay stamp duty in accordance with the Stamp Duty Law. Taxable documents refer to the contracts, property transfer documents and business accounting books specified in the Stamp Duty Law. As the certificates for the dividends and fund distribution received by the investors are not within the scope of dutiable documents specified in the Stamp Duty Law, stamp duty is generally not applicable.

Upon transfer

- As the certificates for the transfer of fund holdings are not within the scope of taxable documents specified in the Stamp Duty Law, stamp duty is generally not applicable.
- If securities transactions are involved during the transfer, the transferor shall pay stamp duty at 1‰ of the trading proceeds.

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Comparison and conclusion

In general, the tax regimes under the two investment channels (e.g. taxation scope, tax basis and tax rate) are largely consistent and the overall tax burden under two channels are close. The main difference is the additional stamp duty implication for institutional investors who trade stocks through QFI.

Apart from direct tax costs, as the tax filing and payment procedures under the two channels are different, the indirect costs arising from tax administration may differ. Under the QFI mechanism, investors will obtain approvals from government authorities before they can settle and remit the income. For example, the in-charge tax authority would require the investor to provide a relevant audit report, tax payment certificate and other documents to prove that the taxes arising from the investment have been fully paid, before issuing a remittance approval upon liquidation of the QFII. It would take a long time and involve many complicated procedures from the settlement of incomes to the issuance of a tax payment certificate, thus increasing the operational costs as well as uncertainties. In comparison, the Stock Connect approach is simplified and can be regarded as a "One Point Connect" model. Under this model, an investor may perform cross-border transactions by submitting trading orders to a local exchange through a local securities trader, with the Hong Kong Securities Clearing Company Limited acting as the registered shareholder for the investments. The investment could be made in the mainland market through Shanghai-Hong Kong Connect or Shenzhen-Hong Kong Connect, resulting in higher efficiency for investment decisions and also reducing the uncertainties and operational costs during the investment process from an investor's perspective.

In addition, from a tax regulatory perspective, the tax rules related to A-shares equity market investment through Stock Connect and QFI mechanism are relatively clearer relative to investing in ETFs through the QFI mechanism. As the respective policies are not clear currently, a case-by-case review and analysis would be required to assess the tax treatment in case of investing in ETFs through QFI.

Both Stock Connect and QFI enable offshore investors to invest in the A-shares market in the Chinese Mainland and investors should choose an appropriate channel based on their circumstances. When comparing these two options, tax cost will inevitably be a key consideration for investors. However, as supported by the analysis, this shall not be limited to direct tax costs, but also operational costs. In addition to tax costs, other factors such as trading flexibility and entry threshold, etc. shall also be considered. In conclusion, investing in ETFs through the Stock Connect as a new investment channel for offshore investors, has certain advantages in terms of overall tax costs, trading flexibility and operational convenience. Investors may pay closer attention and conduct their research so as to optimise their investment models and structures.

Note: In case of any discrepancies in interpretation, the Chinese version of this article shall prevail.

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