HONG KONG TAX ALERT

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“Through train” back on track.

Pilot programme establishing mutual stock market access between Mainland China and Hong Kong announced. New rules to allow direct share trading between Hong Kong and Shanghai could be in place within six months.

In a welcome development, Premier Li Keqiang recently announced in Hainan, during the Boao Forum for Asia, that two-way stock trading between the Shanghai and Hong Kong stock markets should be operational by October. The Hong Kong Securities and Futures Commission and the China Securities Regulatory Commission have, simultaneously, confirmed the development of a pilot programme for the establishment of mutual stock market access between Mainland China and Hong Kong that would see over 820 large and mid-cap stocks being eligible for cross-border trading. It is anticipated that both the Hong Kong and Shanghai exchanges will conclude an agreement soon to give effect to this.

Very little details have been made available to date. However, from what has been reported in the media, it would appear that through the “northbound trading link” Hong Kong and international investors will be able to buy and sell over 560 Shanghai listed stocks through Hong Kong brokers. These brokers will route the transactions through the Hong Kong bourse to the Shanghai exchange. Under the proposals, Hong Kong investors will be able to trade up to 300 billion yuan of A-shares subject to a maximum of 13 billion yuan per day. This annual quota is a little more than half the combined Qualified Foreign Institutional Investor (QFII) and Remnimbi Qualified Foreign Institutional Investor (RQFII) quotas.

Similarly, the “southbound trading link” will enable mainland institutions and individuals to trade up to 266 Hong Kong listed stocks. The maximum total quota is 250 billion yuan of Hong Kong stocks (limited to 10.5 billion yuan per day) and the trades will be lodged with mainland brokers who will then place the orders with the Shanghai Stock Exchange, who will in turn pass them onto the Hong Kong Exchange. The southbound annual quota is less than 50% of the cumulative Qualified Domestic Institutional Investor (QDII) quota.

It is expected that the Through Train arrangement will, for the foreseeable future, complement (as opposed to replace) the existing QFII/RQFII and QDII schemes. This obviously offers something new to mainland Chinese investors who can now invest in economic sectors that were previously unavailable to them. It is also expected that that there will be an increase of retail investors investing in the mainland market.

The above quotas have no time frame and Beijing has not said if it will replenish the quota if and when it may run out. It is therefore feasible that, in due course, the quotas will be lifted although the Hong Kong Financial Services Minister has already cautioned investors not to expect an immediate uplift in quotas once the existing quota is filled.

The proposed scheme raises some questions regarding taxation and the implementation of double tax relief under the Hong Kong and China double tax agreement. It is likely that these will become more apparent the closer we get to implementation of the "through train".

In the 11 years that the QFII scheme and the more recent RQFII regime have been operating, there have been practical uncertainties regarding the China tax consequences of such investments. Although one can reasonably assume the tax consequences based on general tax principles, there have been operational discrepancies for foreign investors as the Chinese tax laws have neither rules governing the administration of taxation of QFIIs/RQFIIs in regard to gains realized on the disposal of investments nor, conversely, a specific exemption for QFIIs and RQFIIs from China taxation. While the Chinese tax authorities were understood to be working on the issuance of detailed implementation rules for the collection of taxes on gains made by QFIIs on trading A-shares, these have not materialized and the tax position regarding both payment and collection remains uncertain.

Consequently important tax questions remain to be definitively clarified (which will also be relevant to the newly proposed investment regime), for example:

- Will the Hong Kong and foreign based investors be subject to withholding tax ("WHT") at 10% on A-share investment in China as regards capital gains and dividends, and if so, will tax treaty relief be available.
- If treaty protection is available for WHT on dividends and capital gains, how does a taxpayer claim treaty protection and what are the prerequisites to such claim?
- Who would be liable for the collection and payment of WHT? How are capital gains to be calculated - on a trade by trade basis or on a pooling basis? What trade related expenses can be deducted from the gain (stamp duties etc)? What about the carry forward or back of trading losses?

A number of the above issues will not necessarily apply to the Through Train regime, but nevertheless they should be addressed and clarified by the Chinese tax authorities particularly as regards the more important issues surrounding capital gains, WHT and treaty benefits.

As the tax treatment of QFII/RQFII is still to be resolved, one would hope that when China finalizes this, by either promulgating laws and/or issuing regulations, the taxation of investors, particularly the mechanics of northbound trading link, will be addressed and certainty attained.

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CONTACTS

Khoon Ming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel: +86 10 8508 7082
khoonming.ho@kpmg.com

Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR
Tel: +852 2826 7165
ayesha.lau@kpmg.com

Chris Abbiss
Partner
Tel: +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Partner
Tel: +852 2826 7166
darren.bowdern@kpmg.com

Barbara Forrest
Principal
Tel: +852 2978 8941
barbara.forrest@kpmg.com

Daniel Hui
Principal
Tel: +852 2685 7815
daniel.hui@kpmg.com

Charles Kinsley
Principal
Tel: +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Partner
Tel: +852 2685 7457
john.kondos@kpmg.com

Alice Leung
Partner
Tel: +852 2143 8711
alice.leung@kpmg.com

Curtis Ng
Partner
Tel: +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman
Principal
Tel: +852 2143 8777
kari.pahlman@kpmg.com

Murray Sarelius
Partner
Tel: +852 3927 5671
murray.sarelius@kpmg.com

John Timpany
Partner
Tel: +852 2143 8790
john.timpany@kpmg.com

Wade Wagatsuma
Partner
Tel: +852 2685 7806
wade.wagatsuma@kpmg.com

Lachlan Wolfers
Partner
Tel: +852 2685 7791
lachlan.wolfers@kpmg.com

Chris Xing
Partner
Tel: + 852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung
Partner
Tel: +852 2143 8753
karmen.yeung@kpmg.com

Kate Lai
Director
Tel: +852 2978 8942
kate.lai@kpmg.com

Alex Lau
Director
Tel: +852 2143 8597
alex.lau@kpmg.com

Benjamin Pong
Director
Tel: +852 2143 8525
benjamin.pong@kpmg.com

Adam Zhong
Director
Tel: +852 2685 7559
adam.zhong@kpmg.com

Justin Pearce
Senior Tax Advisor
Tel: +852 2143 8756
justin.pearce@kpmg.com