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Legal Commentary



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Overview of the EIT Treatment on Interest Income Earned by QFII and RQFII

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On March 4, 2013, the Shenzhen branch of the China Securities Depository and Clearing Company Limited (“CSDCC”) issued the *Notice on Payment of After-tax Bond Interest to QFIIs (RQFIIs)*¹ (*Zhong Guo Jie Suan Shen Ye Zi [2013] No.6*) (“**Notice**”). The Notice states that according to the *Provisional Measures on the Administration of Withholding at Source of Income Tax of Non-resident Enterprises (Guo Shui Fa [2009] No.3)* (“**Circular 3**”), bond interests obtained by QFIIs and RQFIIs are subject to an Enterprise Income Tax (“**EIT**”), and bond issuers are the withholding agent (“**Withholding Agent**”) for such EIT. Accordingly, the Shenzhen branch of the CSDCC specifies that it would generally pay after-tax bond interests when carrying out payments to those claims registered after March 1, 2013. The EIT withheld would be returned to the relevant bond issuers, and then be paid directly to the local tax authorities by the bond issuers.

By adopting this withholding approach, it can be ensured that the tax on the interest income of QFIIs and RQFIIs can be withheld in a timely manner in accordance with Circular 3 as well as other relevant tax laws and regulations. This commentary hereby briefly summarizes the relevant laws, regulations, and policies of the People’s Republic of China (the “**PRC**” or “**China**”) in relation to the withholding of the EIT on the interest income of both QFIIs and RQFIIs.

Tax Treatment of QFIIs and RQFIIs’ Interest Income

Under the *Law of the PRC on Enterprise Income Tax* that came into effect on January 1, 2008 (the “**New EIT Law**”), enterprises are divided into resident and non-resident enterprises. According to the New EIT Law, a non-resident enterprise refers to an enterprise lawfully incorporated pursuant to the laws of a foreign country/region, which is not effectively managed

¹ QFII is the abbreviation for “Qualified Foreign Institutional Investor,” and RQFII stands for “RMB (Renminbi) Qualified Foreign Institutional Investor.”

in China and either (i) has set up an establishment/place of business within the PRC or (ii) derives PRC-sourced income despite the lack of an establishment/place of business within the PRC. Pursuant to the *Measures on the Administration of Domestic Securities Investment by QFIs* and the *Pilot Measures on Domestic Securities Investments by RQFIs for Fund Management Companies and Securities Companies*, only institutions incorporated outside the territory of the PRC may be eligible to be QFIs or RQFIs, and the QFIs and RQFIs' place of effective management is usually located outside of China. Therefore, QFIs and RQFIs may in principle be recognized as non-resident enterprises defined in the New EIT Law.

According to the New EIT Law, non-resident enterprises are subject to EIT on its China sourced income in the absence of an establishment/place of business in China. Non-resident enterprises' China-sourced income includes dividends and interests it received from domestic investees. Pursuant to the New EIT Law and its implementing rules, the total amount of China-sourced interest income derived by a non-resident taxpayer shall be subject to an EIT at the rate of 10%. The *Notice on Relevant Issues Regarding the Withholding of Enterprise Income Tax on Dividends, Bonuses, and Interests Paid by Chinese Resident Enterprises to QFIs* (Guo Shui Han [2009] No. 47) ("**Circular 47**"), which was promulgated by the State Administration of Taxation (the "**SAT**") on January 23, 2009, has further clarified that QFIs are liable to a 10% withholding EIT for their dividends and interests income derived from China in accordance with the New EIT Law. In the event that the relevant tax treaties/arrangements between the QFIs' resident jurisdiction and the PRC provide for a more preferential tax rate or withholding arrangement with respect to dividends and interests, the QFIs may apply to the relevant tax authorities in order to benefit from such treatment. Circular 47 should be applicable to RQFIs as well.

EIT Withholding Mechanisms on the Interest Income of QFIs

Pursuant to the New EIT Law and Circular 3, the EIT on the China-sourced income of non-resident enterprises should be withheld at the source of the income. The Chinese payer (either obligated to pay the non-resident enterprise by law or contractual arrangement) should act as the Withholding Agent, and withhold and deduct the EIT payable by the non-resident enterprise from the relevant payment. The Withholding Agent should file and pay the EIT withheld to the relevant tax authorities within 7 days from the date of withholding, together with the submission of an "EIT Withholding Report" and other relevant documents. The SAT further specifies in Circular 47 that the bond issuers should withhold the EIT charged on the China-sourced interest income of QFIs when such interest is paid or becomes payable.

In practice, bond issuers often entrust the CSDCC to handle bond interest payments. Pursuant to the CSDCC's *Rules on Bond Registration, Depository, and Clearing Business*, after the full amount of interests payable to bond holders and the service fees payable to the CSDCC have been transferred by bond issuers to the CSDCC designated bank account, the CSDCC

shall pay the interest to the relevant securities companies and other institutions (“**Redemption Institutions**”) through a fund clearing system. Thereafter the bondholders may withdraw the interest from the Redemption Institutions. In the CSDCC’s *Implementing Rules for Registration and Settlement of Domestic Securities Investments of QFIs*, it specifies that the interests payable to QFIs would firstly be paid to the Custodian Banks of QFIs, which will then distribute the interests to the relevant QFIs.

The Notice specifies that the Shenzhen branch of the CSDCC will withhold the EIT when paying bond interests to the Custodian Banks of QFIs. However, as the bond issuers themselves are the statutory Withholding Agents for the EIT withheld, the Shenzhen branch of the CSDCC would return the EIT withheld to the bond issuers to allow the bond issuers to directly pay the withheld EIT to the relevant tax authorities.

Having the CSDCC, a professional institution, withhold the EIT payables of QFIs and RQFIs could relieve the bond issuers from the burden of calculating and withholding the relevant taxes. It could also help avoid improper withholding practices (e.g. failures to withhold the relevant taxes in a timely manner, wrongful calculation of applicable taxes, etc.) due to the bond issuers’ ignorance of the relevant tax laws and regulations. Such arrangement could prevent the government from losing its tax revenue. In addition, it is also helpful for QFIs and RQFIs to apply for a Tax Certificate for Outbound Payment,² when the custodian banks release the payment.

It should be noted that Circular 3 requires the Withholding Agent to pay the EIT withheld to the relevant tax authorities within 7 days from the date when the taxes are withheld. As it may take extra time for the CSDCC to return the EIT withheld to the competent bond issuers, the issuers shall promptly pay the withheld EIT to the appropriate tax authorities upon receiving the EIT returned by the CSDCC. Although the Notice does not contain any provisions regarding business taxes or surcharges, the interest income of QFIs and RQFIs is also subject to those taxes. Thus, the bond issuers may still have to withhold those taxes in practice. According to the relevant regulations, the Notice may only apply when an enterprise listed in the Shenzhen Securities Exchange entrusts the Shenzhen branch of the CRDCC to handle its bond interests payment. When an enterprise listed in the Shanghai Securities Exchange entrusts the Shanghai branch of the CRDCC to handle its bond interest payment, the tax withholding mechanism would be determined in accordance with the relevant regulations provided by the Shanghai branch of the CRDCC.

² According to *the Notice of the State Administration of Foreign Exchange and the State Administration of Taxation on Issues relating to the Provision of Tax Certificate for Outbound Payments under Service Trade, and etc. (Hui Fa [2008] 64)*, where domestic organizations or individuals intend to make a single-sum of bond interest payment or certain other kinds of payment equivalent to more than US\$30,000 (excluding US\$30,000 equivalent) to foreign parties, it shall apply for a "Tax Certificate for Outbound Payments under Service Trade, Gains, Current Transfers and Certain Capital Projects" with the relevant tax authorities pursuant to the relevant State provisions. This "Tax Certificate" confirms the full payment of the relevant PRC taxes on the income to be repatriated.

Important Announcement

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