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Tax Newsflash

Temporary tax exemption granted for bond interest derived by foreign institutional investors

On 22 November 2018, China's Ministry of Finance (MOF) and the State Administration of Taxation (SAT) published guidance (Caishui [2018] No. 108 (Circular 108)) that grants a three-year income tax and VAT exemption for foreign institutional investors on bond interest derived from the Chinese bond market. The exemption applies retroactively for the period 7 November 2018 to 6 November 2021. The income tax exemption applies to foreign institutional investors that do not have an establishment in China, or if there is an establishment(s) in China, the bond interest is not effectively connected with the establishment(s).

Background

Currently, foreign institutional investors can invest in bonds in the Chinese bond market mainly through the following channels:

- Direct investment in bonds traded on the China Inter-bank Bond Market (CIBM);
- Qualified Foreign Institutional Investors (QFII)/RMB Qualified Foreign Institutional Investors (RQFII) investment scheme, which allows foreign investors to invest in bonds traded on the Shanghai and Shenzhen stock exchanges or on the CIBM; and
- Bond Connect scheme, a mutual market access scheme between Mainland China and Hong Kong that allows foreign investors to invest in bonds traded on the CIBM.

The tax treatment of bond interest derived by foreign institutional investors[1] has been an area with limited specific guidance and, therefore, practices may vary.

Enterprise income tax

Generally, interest income derived by a foreign institutional investor attracts a 10% withholding income tax if the interest is borne by a Chinese enterprise, unless the rate is reduced under an applicable tax treaty or an exemption is available under domestic law (e.g. interest income derived from state /local government bonds is exempt).

Practically speaking, the 10% tax withholding mechanism was a well-established practice for QFIIs/RQFIIs' investment in bonds traded on the Shanghai/Shenzhen stock exchanges before Circular 108 was issued. However, as a result of certain practical difficulties caused by the CIBM bond registrar, no withholding mechanism has actually been in place for bonds traded on the CIBM and, therefore, a foreign investor normally receives the interest without any income tax being deducted.

VAT

Generally, a foreign lender is subject to a 6% withholding VAT on its interest income derived from loans/financing services provided to a Chinese borrower, unless an exemption is available (e.g. a VAT exemption is available for interest income derived from state/local government bonds).

Practically speaking, the 6% VAT rarely has been withheld from interest income paid to foreign institutional investors. In certain cases, the Chinese tax authorities have asked QFIIs/RQFIIs to file and pay the 6% VAT on interest income that was not withheld by the interest payer before the QFII/RQFII is allowed to repatriate the relevant profits overseas.

Comments

The announcement of the income tax and VAT exemption on bond interest is anticipated to boost foreign investment in Chinese bond markets. However, some uncertainties remain:

- Circular 108 is not entirely clear on whether the exemption applies to interest arising on 7 November and thereafter or whether it applies to interest that is due on or after 7 November; and
- Circular 108 is silent on the tax treatment for the period before the exemption applies.

In light of the above, foreign institutional investors may wish to consider whether they should make provisions for the income tax and VAT on interest income derived before 7 November 2018, and closely monitor future developments.

[1] For the purpose of this discussion, foreign institutional investors are presumed to be nonresident enterprises that do not have an establishment in China.

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