ETF taxation report for mainland Chinese investors

EY 安永
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Introduction

Exchange Traded Funds (ETFs) continue to gain popularity by investors as an efficient mechanism to gain a broad array of desired market exposure. Whilst return on investment (ROI) is a key priority, costs play an important role in maximizing ROI. One significant yet lesser understood cost with investing in ETFs is taxation. This is especially true for any cross-border investments which are normally subject to multiple instances of taxation.

In this report we will examine the impact of different types of ETFs on mainland Chinese based investor returns across key markets, ETF types and domiciles.

Multiple instances of taxation on ETFs

An investor's ETF returns can generally be subject to tax at three levels:

- **Investment level** – Withholding tax (WHT) on interest, dividends and capital gains in the source country of investment
- **Fund level** – Taxes applied at the fund level including direct taxes, net asset taxes and stamp duty/transaction taxes
- **Investor level** – WHT on ETF distributions to the investor and tax on exit

The extent of tax cost impacting an investor's returns will vary widely depending on the domicile and type of ETF, domicile of the investor and jurisdiction of the underlying securities within the ETF.

Of these factors, the domicile and type of ETF will be especially important because this will dictate:

- The rate of WHT applied at both the investment and investor levels
- The taxes applied at the fund level (if any)
- The requirements that must be satisfied for treaty access where available

Key ETF markets

Mainland Chinese investors have typically demanded exposure to the following markets: Germany, Japan, Korea, Hong Kong, Taiwan, the United Kingdom and the United States.

Investors may seek out both single jurisdiction ETFs as well as broader regional or global ETFs to meet their exposure needs.

Types of ETFs compared

Common forms of ETFs include the following:

- Hong Kong domiciled funds, listed on the HKEX
- Irish Collective Asset-management Vehicle (ICAV) authorized as an Undertaking for Collective Investment in Transferable Securities (UCITs)
- Luxembourg Société d'Investissement à Capital Variable (SICAV)/Société d'Investissement à Capital Fixe (SICFs)
- US Regulated Investment Companies (RICs)

In order to demonstrate the potential differences in after tax returns on interest and dividends for mainland Chinese residents investing through these types of ETFs, we have prepared the following analysis. Please note, this analysis is general in nature.

The following analysis considers only the impact of tax on dividend and interest income. It will also be important to consider the impact of tax on disposals of units/shares giving rise to capital gains and the availability of foreign tax credits.

Assumptions

The requirements to obtain treaty benefits are complex and varied and may include the ability of the fund to obtain a certificate of residency or demonstrate to the local tax authority that it, or persons who could claim similar benefits, are the beneficial owners of such income. These requirements may be more difficult to satisfy in particular jurisdictions.

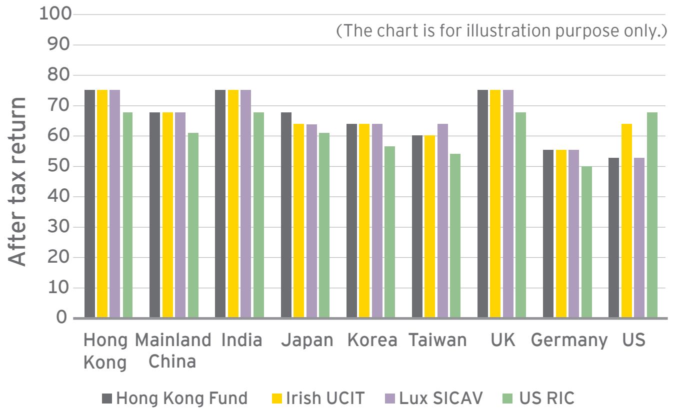
In preparing our analysis, we have made the following specific assumptions:

1. The US ETF will qualify as a RIC for the relevant year and satisfy the relevant annual distribution requirements such that it should not be subject to US federal income tax on its investment company taxable income distributed to stockholders
2. The Irish UCIT's principal class of shares is substantially and regularly traded on a recognized stock exchange
3. All investors are institutional corporate investors and tax residents in mainland China
4. All the ETFs are beneficial owners of mainland Chinese source income and entitled to treaty benefits accordingly

Ultimately, the ability to claim treaty benefits by the ETF or mainland Chinese investor will depend on their individual facts and circumstances. These requirements should be assessed in detail before making any investment decision.

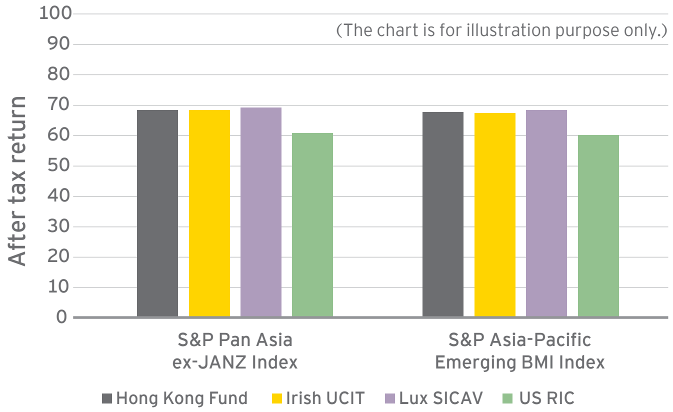
Mainland Chinese investor after tax returns compared

Figure 1. Mainland Chinese investor after tax return for dividend



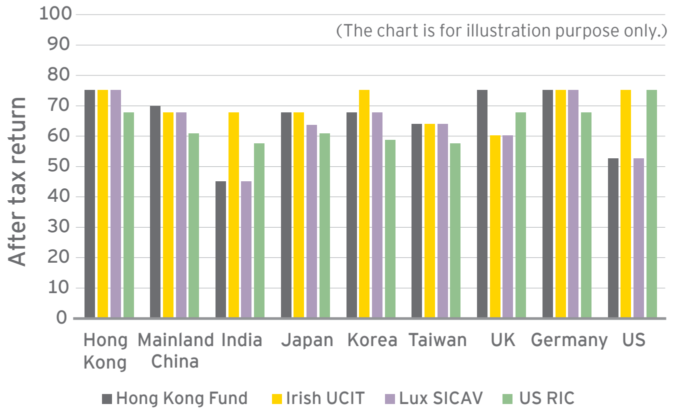
The German dividend withholding tax rate reflected above is the statutory withholding tax rate at source. Irish UCITs, Luxembourg SICAV/SICFs and US RICs may be treaty eligible for a net withholding tax rate of 15%. Nonresident investors may be entitled to reclaim the excess withholding tax of 11.375%.

Figure 2. Mainland Chinese investor after tax return for dividends from Asian indices



Based on index constituents' jurisdiction domicile as of 28 February 2017 provided by the Hong Kong Exchange.

Figure 3. Mainland Chinese investor after tax return for interest from corporate bonds



Key findings

Our analysis demonstrates that Hong Kong domiciled funds are tax efficient for mainland Chinese investors compared to other popular vehicles with two key exceptions:

- Irish UCITs and US RICs are potentially more tax efficient when investing into US equities
- Luxembourg SICAV/SICFs offer potentially the lowest rates of withholding taxes when investing into Taiwan listed equities

Our analysis also demonstrates that US RICs generally offer the highest rate of withholding taxes for mainland Chinese investors when investing into Asian markets.

With regards to popular indices, Hong Kong domiciled funds remain highly competitive compared to other popular vehicles.

Similarly, from a corporate bond perspective, Hong Kong Funds remain competitive, especially in respect of mainland China and the UK.

However, the following ETFs offer key advantages when investing into certain markets:

- Irish UCITS when investing into India, Korea and US Bonds
- US RICs when investing into Indian and US bonds

Conclusion

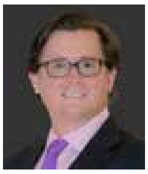
Hong Kong domiciled ETFs have traditionally been recognized for their unique access to the mainland Chinese domestic market. However, with the HKEX now carrying over 150 ETFs[1] representing a wide range of global markets investors now have an enhanced ability to use Hong Kong ETFs to achieve their desired market exposures.

Furthermore, Hong Kong's expanding treaty network and domestic tax rules offer significant benefits for mainland Chinese based investors seeking to invest via Hong Kong ETFs to gain exposure to other Asian and global markets.

Mainland Chinese investors should however be aware of the potential costs of investing into certain markets through a Hong Kong domiciled fund, such as the US.

[1] Source: Hong Kong Exchange official webpage (August 2017)

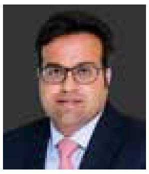
Contact us



Elliott Shadforth
Wealth and Asset
Management Leader,
Ernst & Young, Hong Kong
+852 2846 9083
elliott.shadforth@hk.ey.com

Jacqueline Bennett
Wealth and Asset
Management Tax Leader,
Ernst & Young Tax Services Limited
+852 2849 9288
jacqueline.bennett@hk.ey.com

Loretta So
Partner, Financial Services Tax,
Ernst & Young (China)
Advisory Limited
+86 21 2228 2882
loretta.so@cn.ey.com



Rohit Narula
Partner, Financial Services Tax,
Ernst & Young Tax Services Limited
+852 2629 3549
rohit.narula@hk.ey.com

Julie Kerr
Director, Business Development,
Ernst & Young Asia-Pacific
Services (HK) Limited
+852 2629 3262
julie.kerr@hk.ey.com

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