ETF taxation report for Mainland Chinese investors 2018

Commissioned by:

HKEX
香港交易所

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 China 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 jurisdiction 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 sort out exposure to the following markets: Hong Kong, India, Japan, Singapore, South Korea, Taiwan, Thailand, Germany, 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.

Regulatory restrictions may exist preventing Mainland Chinese corporate investors investing into certain types of ETFs. Investors should seek separate legal and regulatory advice in this regard as the analysis in this report is focused solely on the potential tax implications of investing into different types of ETFs.

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.

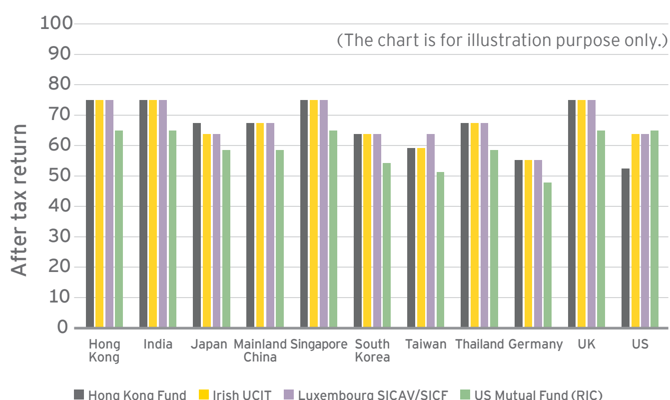
In preparing our analysis, we have made the following specific assumptions:

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 the relevant income and therefore 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.

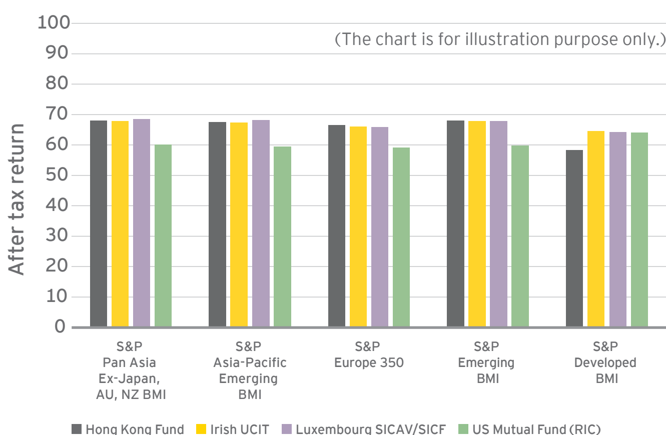
Mainland Chinese investor after tax returns compared

Figure 1. Mainland Chinese investor after tax return for dividends



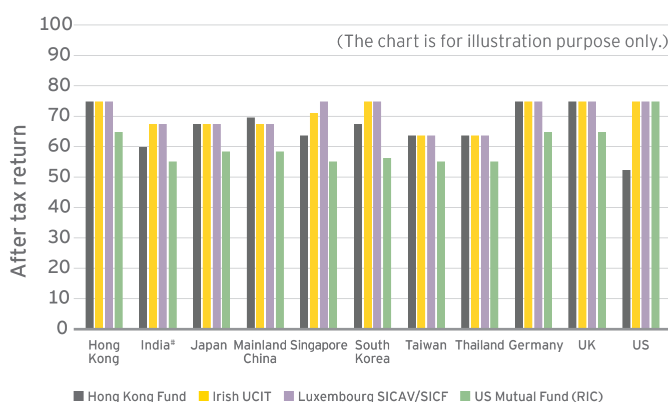
The German dividend withholding tax rate reflected above is the statutory withholding tax rate at source, i.e., 26.4%. A better outcome may be achieved where tax treaty relief can be availed.

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



Based on index constituents' jurisdiction domicile as of 31 December 2017 provided by the HKEX

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



#Please note that Hong Kong and India recently signed a double tax avoidance agreement (DTAA) on 19 March 2018 which is pending ratification. A reduced withholding tax rate may be available for interests arising from corporate bonds in India invested via Hong Kong Funds after the tax treaty enters into force.

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, Luxembourg SICAV/SICFs 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, with the exception of investing into underlying US equities.

With regards to popular indices, Hong Kong domiciled funds generally remain competitive compared to other popular vehicles, except S&P Developed BMI of which more than half of the underlying investments are domiciled in the US*. This reflects the fact that Hong Kong does not have a tax treaty with the US. Other than the above, Hong Kong domiciled funds are generally preferable to US RICs for Mainland Chinese investors from a tax efficiency perspective.

From a corporate bond perspective, Hong Kong Funds remain competitive, however, the following ETFs offer key advantages when investing into certain markets:

- Irish UCITs and Luxembourg SICAV/SICFs when investing into India, Singapore, South Korea bonds
- Irish UCITs, Luxembourg SICAV/SICFs and US RICs when investing into US bonds

*Based on index constituents' jurisdiction domicile as of 31 December 2017 provided by the HKEX.

Conclusion

Hong Kong domiciled ETFs have traditionally been recognized for their unique access to the domestic market of Mainland China. However, with the HKEX now carrying over 130 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 China 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: HKEX official webpage (May 2018)

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There are over 130 ETFs and Leveraged & Inverse Products in Hong Kong providing access to a world of asset classes, markets and strategies. Quickly becoming Asia's ETF marketplace, HKEX has a diverse, liquid and tax efficient product offerings during Asian trading hours.

www.hkex.com.hk/ETF

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