ETF taxation report for investors

Mainland China

September 2021

Commissioned by:

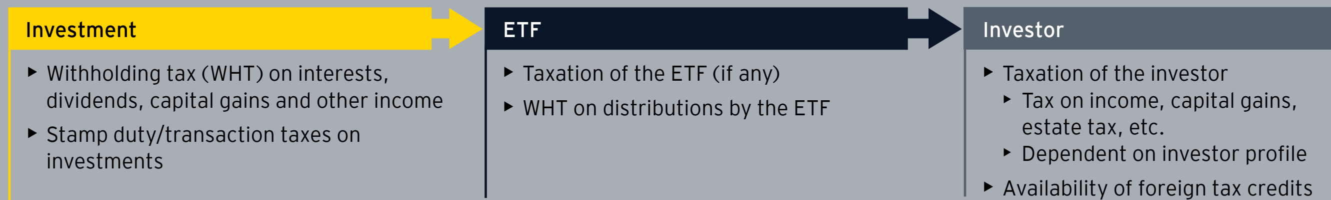
Introduction

Exchange Traded Funds (ETFs) continue to gain popularity by investors as an efficient mechanism to gain a broad array of desired market access. While 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, EY teams 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:



The extent of tax costs will vary widely depending on:

1. Domicile of the investor
2. Domicile and type of ETF*
3. Jurisdiction of the underlying portfolio investments

*Especially important because this should have an impact on the following:

- The applicable WHT rate at both the investment and investor levels
- The applicable taxes at the ETF level
- Access to any available tax treaty benefits

Types of ETFs compared

Common forms of ETFs compared in this Report include the following:

- Hong Kong ETF is a Hong Kong unit trust authorized by the Securities and Futures Commission of Hong Kong.
- The Irish ETF is an Irish Collective Asset-management Vehicle (ICAV) authorized as an Undertaking for Collective Investment in Transferable Securities (UCITS).
- Luxembourg ETF is a capital company constituted as a Société d'Investissement à Capital Variable (SICAV)/Société d'Investissement à Capital Fixe (SICAF).
- US ETF is a Regulated Investment Company and satisfies specific requirements.

General basis of preparation

1. This Report is general in nature.
2. It does not consider any transfer taxes such as stamp duty.
3. It considers only income tax/WHT effect on dividend and interest income received by the ETFs, and excludes capital gains tax or tax on trading profits/losses.
4. The distribution from ETFs are considered to be normal dividend and/or distribution (practically subject to local variances).
5. All investors are institutional corporate investors and tax residents in their domicile location(s), and subject to standard corporate income tax rate. Individual circumstances have not been considered.
6. To the extent domestic unilateral tax credit is available and considered, it is assumed that the necessary criteria are satisfied and the available tax credit will be within the prescribed limit.
7. Some jurisdictions may have regulatory restrictions on cross-border investments. Investors should seek separate legal and regulatory advice in this regard as this Report focuses solely on the potential tax implications of investing into different types of ETFs.
8. It does not consider any EU non-discrimination directives or relevant rules.

Application of reduced tax treaty rates

1. We have assumed the following minimum conditions for tax treaty eligibility are met:
   - ETFs are assumed to be the tax residents in their domicile and are able to obtain certificates of residence from their respective local tax authorities.
   - ETFs are assumed to be regarded as beneficial owner of the income.
   - ETFs are assumed to hold less than 5% of the total share capital of a single investment.
2. Ultimately, the ability to claim tax treaty benefits by ETFs and investors depends on each of their individual facts and circumstances in meeting the prescribed conditions under the relevant tax treaty provisions or domestic laws for domestic relief (if any). This is also subject to the practices of ETF sponsors, withholding agents and the local tax authorities in each jurisdiction. Each investor should consult its own tax advisor regarding the specific requirements to qualify for tax treaty benefits under the relevant tax treaties.
3. Indian Finance Act, 2020 abolished dividend distribution tax and replaced it with a new regime where dividend is taxed in the hands of the recipients from 1 April 2020 by way of withholding. In consideration of treaty benefits, it is assumed that foreign ETFs investing into India are not a fiscally transparent entity, Indian general anti-avoidance rule is not triggered and other treaty conditions are met. In practice, Irish and Luxembourg ETFs may have difficulty to enjoy the treaty benefits and thus no treaty benefits are considered for them.
4. The Government Regulation No 9/2021 in Indonesia reduced the statutory corporate bond interest paid to all non-resident holders from 20% to 10% (or the applicable tax treaty rate, if lower) for interest income received on or after 2 August 2021. Since the cut-off date for data in this Report is 30 June 2021, the captioned change has not been reflected.

Other jurisdiction-specific assumptions

1. The Irish ETF principal class of shares is substantially and regularly traded on a recognized stock exchange.
2. All US-sourced dividends are considered ordinary dividends for US federal income tax (US Tax) purposes.
3. All US-sourced government and corporate interests qualify for the portfolio debt exemption under section 881(c) of the US Internal Revenue Code of 1986, as amended and currently in effect, for US Tax purposes.
4. Non-resident institutional investors are temporarily exempt from WHT with respect to interest income derived from Mainland China corporate bonds (from 7 November 2018 to 6 November 2021).

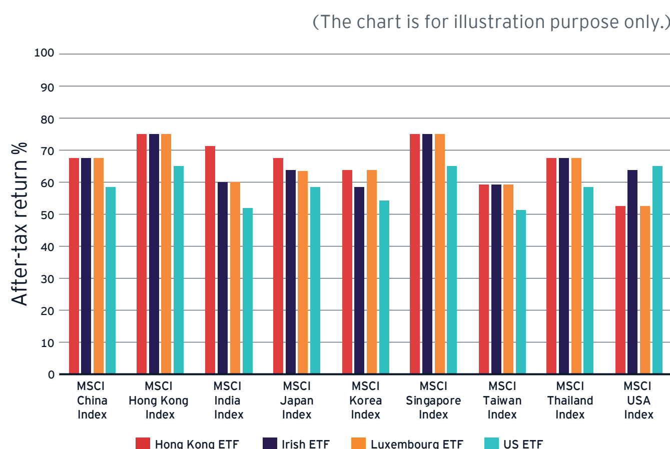
This Report is prepared for informational purposes and supported by the ETF Tax Calculator. It sets out the key summary of the preparation basis as well as underlying assumptions. For more details, please visit: **www.hkex.com.hk/ETFTaxCalculator.**

Mainland China investor after-tax returns compared

Figures 1 to 3 below depict the percentage of expected after-tax return for institutional corporate investors from investing into different domiciled ETFs which seek to track the investment results of the same selected equity/fixed income index. It is assumed that different domiciled ETFs tracking the same index would generate the same ETF distribution before all level of taxes**. The illustrative diagram provides further illustration on an example index in Figure 1.

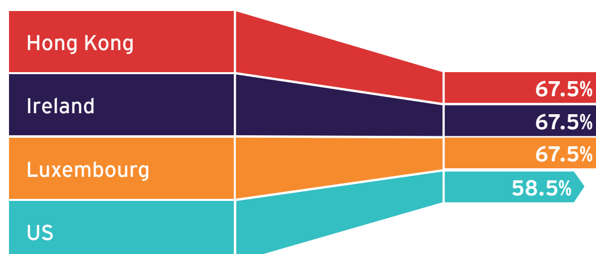
Figure 1. Single market equity indices***

(The chart is for illustration purpose only.)



Illustrative diagram for MSCI China Index (Figure 1)

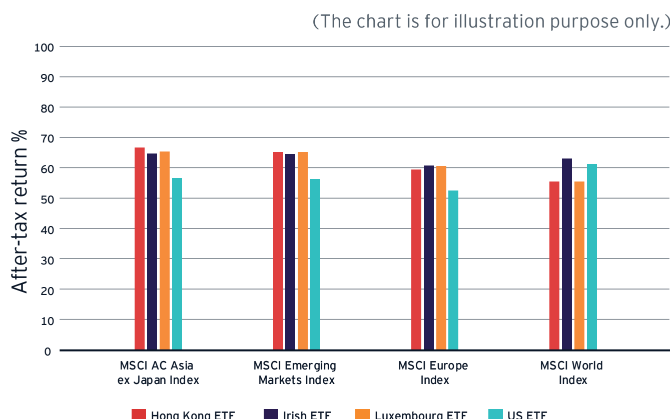
For Mainland China investors, by investing in MSCI China Index through a Hong Kong ETF, the after-tax return from ETF distribution should be 67.5% of the ETF distribution before all level of taxes**, versus 58.5% using a US ETF.



**This includes portfolio level, ETF level and investor level, and does not take into account any fees to intermediates.

Figure 2. World/regional equity indices***

(The chart is for illustration purpose only.)

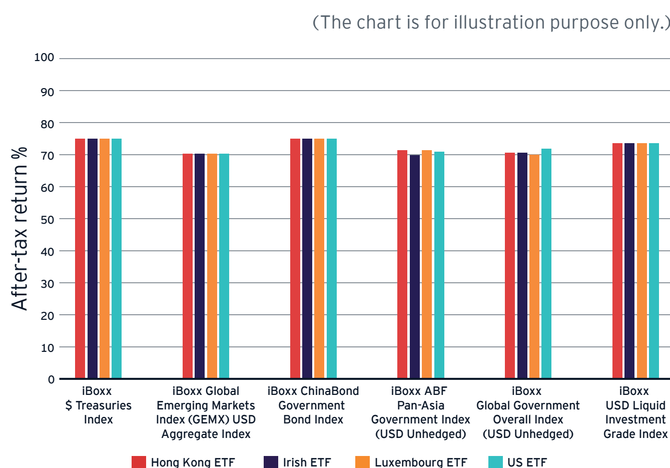


Consider total cost of ownership (TCO) including tax

This Report provides evidence that significant differences can arise in after-tax returns for ETFs domiciled in different jurisdictions. However, tax should not be the only consideration in ETF selection. Investors should evaluate ETF investment costs in the context of the TCO, including but not limited to bid-ask spread, broker commissions, total expense ratio and taxation. For more details about TCO, please read the *ETF Total Cost of Ownership primer* in the HKEX ETF webpage.

Figure 3. Fixed income indices***

(The chart is for illustration purpose only.)



*** This Report is prepared based on the index constituents data and the applicable tax rates as of of 30 June 2021. The index constituents data is provided by MSCI and IHS Markit respectively. For MSCI indices, the jurisdiction classification is generally determined by the company's location of incorporation and the primary listing of its securities. For IHS Markit indices, the jurisdiction weight is based on the jurisdiction where the issuer is exposed to. EY and HKEX are not responsible for independently verifying or validating the source data.

Why Hong Kong ETFs?

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 more than 140 ETFs and Leveraged and Inverse Products representing a wide range of global products, investors now have an enhanced ability to use Hong Kong ETFs to achieve their desired market exposures.

Furthermore, Hong Kong's ETF market, as a regional issuing and trading hub of ETFs, is seeing deepening liquidity driven by a continuously enhancing market structure. This translates into narrower bid-ask spread and lower trading cost for investors seeking to gain exposure to Asia and beyond via Hong Kong ETFs.

Investors can also benefit from lower tracking difference, which is a component of TCO, by trading Asia underlyings in the Asian time zone with Hong Kong ETFs as they can react to events occurring in Asia more timely.

Hong Kong ETFs may offer a tax-efficient, low-cost vehicle for investors to access a diverse range of asset classes and markets.

To learn more about Hong Kong ETFs, please visit the HKEX ETF webpage **www.hkex.com.hk/etp**.

To see the after-tax returns comparison on more indices, please visit: **www.hkex.com.hk/ETFTaxCalculator**.

Contact EY teams

Elliott Shadforth
EY Asia-Pacific Wealth & Asset Management Sector Leader, Ernst & Young

+61 2 9248 4546
elliott.shadforth@au.ey.com

Rohit Narula
EY Asia-Pacific FSO International Tax & Transaction Services Leader
Ernst & Young Tax Services Limited

+852 2629 3549
rohit.narula@hk.ey.com

Loretta So
Partner, Financial Services Tax
Ernst & Young (China) Advisory Limited

+86 21 2228 2882
loretta.so@cn.ey.com

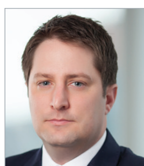
Ming Lam
Director, Financial Services Tax
Ernst & Young Tax Services Limited

+852 2849 9265
ming.lam@hk.ey.com

Candice Fan
Partner, Financial Services Tax
Ernst & Young (China) Advisory Limited

+86 21 2228 4330
candice.fan@cn.ey.com

Contact HKEX



Brian Roberts
Head of Exchange Traded Products,
Hong Kong Exchanges and Clearing Limited

+852 2840 3396
brianroberts@hkex.com.hk

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HKEX launched the pioneering Shanghai-Hong Kong Stock Connect programme in 2014, further expanded with the launch of Shenzhen Connect in 2016, and the launch of Bond Connect in 2017.

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