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Shanghai Expended the Boundaries of the QFLP Scheme

As China expedites the opening-up of its financial sector, Shanghai continues to be the vanguard through its introduction of new models and investment scope as part of the Qualified Foreign Limited Partnership (QFLP) scheme. These are welcome signs to foreign asset managers looking to invest in a broader range of Chinese asset classes such as distressed debts.

Before pursuing this new structure, foreign asset managers should be wary of the tax implications. This is particularly important for those investing into the Chinese capital market via a niche structure such as a QFLP, where the absence of relevant tax regulations and inconsistencies in local practices bring more tax uncertainties.

In a recent press interview, Mr. Li Jun, the deputy director-general of the Shanghai Municipal Financial Regulatory Bureau announced the expanded scope of the QFLP scheme in Shanghai. In addition to the existing model where a foreign fund manager manages a USD-denominated funds, the new scheme now includes two new models, namely 1. foreign fund manager managing RMB-denominated funds and; 2. domestic fund manager managing USD-denominated funds.

The new QFLP scheme has also expanded the investment scope of QFLP funds from equity investments to investments in preferred shares, private placement, convertible bonds, mezzanine debt and distressed debt. This broadens the asset classes foreign asset managers can access via the QFLP structure, especially in the non-performing loans (NPLs) market. A QFLP fund, being a limited partnership, offers legal and commercial flexibility as well as tax benefits, and should therefore be a welcomed structure for foreign investment in NPLs.

From a tax angle, under the previous model, foreign investors could invest in the domestic NPL market with a wholly foreign owned enterprise (WFOE). The NPL WFOE's profits would be subject to China corporate income tax at the rate of 25%. Upstream dividend repatriation to a foreign investor would attract China withholding income tax of 10%. This represents an effective income tax cost of 32.5%[1]. In contrast, a QFLP fund in the form of a limited partnership is aquasi-see-through entity for corporate income tax purposes. As such, gains derived by the fund are only taxed once at the partners' level. The QFLP therefore seems to be a more tax efficient structure for foreign investors. While this is true in a technical sense, existing Chinese tax laws and regulations are not entirely clear on the taxation for the foreign limited partners of the QFLP fund. This means that the effective tax rate of the foreign limited partners under a QFLP fund may vary according to local practices.

Foreign asset managers thinking of using a QFLP structure to make NPL investments into China will face various tax uncertainties, such as: will the foreign limited partners under a QFLP fund create a permanent establishment in China and trigger 25% PRC corporate income tax on the profit allocated from the fund? or, will the profit allocated from the QFLP fund be passive income derived by the foreign limited partners and subject to a withholding tax at 10%? Can foreign limited partners make use of tax treaties to reduce the China income tax on the profit allocation from the QFLP fund?

At the QFLP fund level, will the Chinese tax authorities accept using recovery on a portfolio basis approach under the tax circular Guoshuifa (2003) No.32 to calculate the foreign limited partners' taxable gains? Will resolution proceeds be subject to VAT at the QFLP fund level? In most cases, QFLP funds operate as small-scale VAT payers. Will fapiao become an issue to the QFLP fund when collecting resolution proceeds?

Tax will have a big impact on the overall investment return. As such, these questions will need to be considered and addressed with care when foreign asset managers are making investment plans under the QFLP structure. The new Shanghai QFLP measures, together with recent reforms, represent Shanghai's commitment to becoming a top tier financial centre.

As foreign asset managers pursue new ways of investment through a QFLP structure, they will face challenges from new uncertain tax issues. Foreign asset managers should closely monitor the developments on QFLP taxation and consider engaging with the Shanghai competent tax bureaus to understand the latest administrative practices to reduce the uncertainty.

If you wish to obtain more information or assistance, please visit the official website of Kaizen CPA Limited at www.kaizencpa.com or contact us through the following and talk to our professionals:
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