

Asia Pacific IMRE News

Informing on the changing face of Asia*

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Vietnam – swift economic growth causes real estate demands to soar

In recent years Vietnam has reached a number of political, economic and regulatory milestones that resulted in a significant increase in interest from the outside world. These include the implementation of the Common Investment Law and the Unified Enterprise Law in effect since July 2006, the hosting of the 14th Asia Pacific Economic Cooperation (APEC) Economic Leaders' Meeting in November 2006 and the admission to the World Trade Organisation in January 2007. Given these achievements, which required years of preparation, it is not surprising that the country is often praised for its political stability, commitment to openness and investor-friendly policies.

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Real GDP has grown at an average rate of 7.6% since 1991 despite the Asian crisis 10 years ago and the forecast average annual growth for 2007-2011 is approximately 8%. Indicators of foreign direct investments are also rising strongly and the main index of the Stock Exchange in Ho Chi Minh City has reached highs above 1000 points in 2007. In comparison, the index closed at 239 points in 2004, at 307 points in 2005 and at 752 points in 2006. A recent PricewaterhouseCoopers' study² found Vietnam to be the most promising emerging market for manufacturing companies. It is not surprising that it is now commonplace to refer to Vietnam as the next Asian tiger.

Vietnam has a young, well educated and growing population that enjoys access to health care and a very low poverty rate. Whilst among the ASEAN member countries Indonesia and the Philippines have bigger populations, the 85 million inhabitants of Vietnam still make the country more populous than any member country of the European Union.

As in all emerging markets, most foreign investors face unique challenges that require special attention. The lack of infrastructure, especially outside big cities, can be limiting and hinder investment despite investment incentives offered by the government. Whilst the cost of blue collar labour remains low even by Asian standards, the shortage of skilled human resources has led to wage inflation in major cities and in certain professions. Despite continuous improvement, standards of corporate governance and transparency are behind international norms. A developing legal framework introduces gaps and inconsistencies in execution.

Overview of Vietnam real estate market

Trends and outlook

With economic growth, increasing income levels and inbound tourism, demand for office and retail space, hotels and modern residential houses have all been solid over the past two to three years. In particular, businesses in Ho Chi Minh City (formerly Saigon) in the south and the capital Hanoi in the north are exposed to office-for-lease shortage and rising rents. Major developments are underway in both cities, mostly driven by Asian investors; however it is uncertain when the rate of growth in supply will be able to match demand.



Ho Chi Minh City tops the 2008 lists of all Asian cities in terms of buy recommendations both for Industrial/Distribution and Apartment residential (rental) property according to the joint annual Emerging Trends in Real Estate® Asia Pacific 2008 survey of PricewaterhouseCoopers and the Urban Land Institute¹. Based on overall investment prospect ratings, Ho Chi Minh City is now seen as one of the top ten locations in Asia.

The retail sector is largely fragmented and currently dominated by family businesses and a handful of local players. However, a number of multinationals are either already present or planning their entry to the market (particularly in view of Vietnam's WTO commitment to allow foreign investors to have 100% foreign-owned retail operations from 2009). Tourism continues to hold great potential in line with the increase in the number of foreign visitors. The country has over 3,000km of tropical coastline and many recent investment projects have focused on the development of seaside resorts. Residential developers in key cities have been enjoying rising demand for high-end condominiums, whilst the mid and low end of the market have been more stable. Due to a general increase in sophistication,

better availability of financing and improved regulatory environment, over the long term urbanisation is expected to be one of the key drivers of the housing market.

Regulatory framework

Core to Vietnam's economic reform have been substantial amendments to the country's legal and regulatory framework. Significant developments have occurred in 2006-2007, driven in particular by Vietnam's WTO accession.

These important legal reforms aim to create a level playing field for foreign and domestic investors in Vietnam and a coherent legal framework for their respective operations.

Going forward, Vietnam's WTO commitments will be the key determinants of whether, or in what form and with which ownership, foreign investment in Vietnam will be permitted.

The legal and regulatory reform has brought about the introduction and/or amendment of laws. However, guiding implementing regulations (in the form of statutory Decree and/or Circular) are still pending. In Vietnam, without implementing guidance, a law, although enacted, cannot in practice

¹ 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

² Emerging Trends in Real Estate® Asia Pacific 2008, produced by the Urban Land Institute and PricewaterhouseCoopers, ISBN: 978-0-87420-994-5.

Legislation permits, but does not specifically encourage, foreign investment in the sector, except in select assets classes and regions where economic development is significantly behind the national average.

be implemented. This is providing an obstacle to investment.

Investment in real estate

Real estate is a conditional investment sector. However, pending further detailed guidance, it is unclear what, if any, additional conditions will apply but speculation has been that the conditions could be in terms of the charter capital, funding guidelines, etc.

Foreign-invested companies incorporated in Vietnam may lease land directly from permitted lessors, including the State, or acquire land via the capital contribution of a Vietnamese partner in the form of the value (or part thereof) of Land Use Rights. Often investment in the more attractive locations/projects in Vietnam will only be commercially/practically possible in this second form.

Legislation permits, but does not specifically encourage, foreign investment in the sector, except in select assets classes and regions where economic development is significantly behind the national average. Therefore, there are limited opportunities for tax incentives in the sector.

Vietnam does not have thin capitalisation rules within its tax regulations. Under the former Law on Foreign Investment, the maximum debt/equity ratio of a foreign-invested enterprise was 70/30. Such condition does not exist in the Law on Enterprise and was removed from the new Law on Investment. However, there is still an implicit limit by virtue of the need to have a stipulated investment capital and charter capital approved by the licensing authority. Accordingly, the difference between the investment capital and charter capital could be treated as the maximum amount of debt for an entity.



Vietnam has to date ratified more than 40 Double Tax Agreements, which provide opportunities for optimising financing and structuring options.

Ownership and permitted activities

The ownership of land in Vietnam is defined as belonging to the country and therefore to the State. There is no private ownership of land. Individuals and organisations may only be granted land use rights for pre-determined purposes and periods and have to pay land rental to the Government. Land use rights can be transferred, except where this is not permitted or is restricted under the law.

Under the Law on Trading in Real Estate, foreign investors may participate in the following real estate activities:

- Housing construction for sale and lease;
- Investment in infrastructure for leasing land;
- Real estate brokerage;
- Real estate valuation;
- Real estate consulting;
- Real estate bidding; and
- Hold real estate transactions floor.

In the past, foreign investors had to set up greenfield projects or buy an interest in a licensed foreign-invested enterprise. Under the new law, foreign investors can also buy shares in an existing domestic company. A regulation on the rights of foreign investors to buy shares in Vietnamese companies is being drafted.

To date, while in theory foreign investors can set up a wholly foreign-owned enterprise for undertaking real estate investments, it is very difficult for foreign investors to gain access to land, particularly in large cities. In this regard, joint ventures are still common. In most cases, the Vietnamese partner will contribute the land to the joint venture.

Australian investment management industry poised to enjoy another stellar year; but there are some clouds on the horizon.

Peter van Dongen summarises some key results from the 2007 Australian Investment Management Survey.

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The crisis in the US sub-prime market notwithstanding, the Australian investment management industry is poised to enjoy another stellar year following a strong 2006-07. According to the PricewaterhouseCoopers "Australian Investment Management Survey 2007", investment managers are experiencing enormous growth and are confident about the future.

The optimism in this industry, which boasts \$A1.2 trillion (\$US1.1 trillion) of assets under management, is hardly surprising. Growth is being fuelled by a strong economy, near full employment, rising wages in a tight labor market, and, most significantly, a compulsory superannuation scheme (with a 9% employer contribution) enjoying bipartisan political support.

None of these factors is likely to turn sour in the short to medium term. Neither is the upcoming federal election causing any ripples on the investment horizon.

But amid a bullish industry outlook the survey did uncover areas of concern; success is encouraging new entrants to enter the market and managers are experiencing pressure on their margins. Innovative managers with long-term strategies will still prosper, but growing competition will almost inevitably result in greater industry consolidation.

Certainly investment managers are acutely aware of increasing competition and tighter margins, particularly in traditional asset classes, and have responded by innovating with new products offering healthier margins. For example, the demand for alternative products, such as private equity vehicles and infrastructure assets, continues to grow; the survey shows 74% of respondents had 0-5% of their assets under management housed in alternative products, but in three years' time, 79% expect to have more than 5% of assets housed there.

Yet for all the growth stimulants and the drive to innovate, the survey shows that investment managers are saying "enough is enough" with their product suites. Interestingly, when asked their key objectives for the business in three years' time, the overwhelming response was to increase distribution of existing products in existing markets. Similarly, the main focus was on retaining clients, not winning new ones.



The investment managers have got it right. There are too many Australian products for the size of this market. Businesses have seen the impact that operational failures can exact on a business; having more products than is necessary is a sure way to increase the inherent risk of such events. Legislative relief for those wanting to rationalise their product suites is overdue.

Coinciding with growing competition is a “war for talent”. Although it is a cliché, it’s an accurate summation of the state of the industry today. The loss of skilled personnel is now rated the “greatest threat” to any organisation, putting it ahead of the critical need to retain valued clients and own funds performance.

In a market becoming increasingly competitive, a shortage of skilled personnel will be accentuated if, as PricewaterhouseCoopers believes, the best way for organisations to differentiate themselves in a crowded marketplace will be to become more customer centric.

So how to find and keep key people will be of paramount importance for all investment managers, irrespective of size. Larger investment managers, in particular, are finding it increasingly difficult to win this war; they face the significant challenge of promise and hope – the promise of riches from the boutique strategy and the hope that it eventuates.

The smaller players can offer greater levels of autonomy, lower levels of internal politics and the excitement of working for an embryonic organisation. The bigger players are looking at measures that replicate these workplace cultures. But it is difficult; workplace cultures are highly resistant to change, and replicating equity-based remuneration incentives requires some fresh thinking.

In any discussion on employees, how they are remunerated is important. But it’s not the only issue; research shows that Gen Y, for example, lists dollars and cents only sixth in importance when deciding to accept a job. The boutiques’ ability to attract talent is further evidence of other factors at play in recruiting and keeping staff.

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Other survey results include:

- Industry acknowledgement of the conflicts of interest confronting financial planners. The industry has always had to recognise and professionally handle conflicts; they have existed since the first advisor/client relationship. But today they are more numerous, broader in dimension and greater in complexity. Most respondents to the survey use disclosure and documented policies and procedures to manage conflicts of interest.
- The importance of distribution was highlighted; when asked to rank the key business objectives in three years, increasing distribution of existing products in today's markets was the outright winner. But at a time when there appears little room to move in traditional distribution channels, it remains a moot point how to achieve this goal.
- Companies that delay meeting their anti-money laundering (AML) requirements under recent Federal Government legislation will pay a high price. Although some parts of the legislation are not finalised, those projects that started early have gained a better control over costs by maximising the available planning and implementation time. Survey results suggest an opportunity to accelerate implementation.
- Demand for investment vehicles that explicitly acknowledge the importance of environmental sustainability is growing apace as institutional investors "reward" companies perceived to be addressing this issue.

Investing in China real estate – A changing landscape

Against the backdrop of continuous double-digit economic growth, rapid urbanisation and the very strong currency, the China real estate market has recorded phenomenal growth in recent years. The phenomenal growth has attracted significant amounts of foreign direct investment in the real estate sector. Many foreign investors now see China as a “must have” in their portfolios¹.

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Despite its attractiveness, China is a very difficult market. As one consultant stated, “China is about as speculative as you can get. The further you are away, the more interesting it looks, but when you’re actually there, you figure out how difficult it is to get something to perform. Deals are getting done, but they’re taking a long time.”² This observation could not be more true, particularly in light of the recent regulatory changes introduced by the Chinese authorities. Foreign investors are becoming increasingly concerned about how these changes may affect their investment structures and returns.

Those were the days...

Until the recent changes, foreign investors had more flexibility in structuring their real estate transactions in China. For an investment property, a foreign investor might simply acquire and hold the property via an offshore special purpose vehicle, as shown in Figure 1.

Apart from its simplicity, the beauty of this offshore holding structure is that the foreign investor does not need to observe the minimum registered capital requirements and other regulatory requirements that would apply to a locally incorporated entity (i.e., a foreign investment enterprise, or an “FIE”). As soon as all the applicable expenses and China taxes have been paid on the income derived from the property, the remaining cash balance may generally be remitted out of China. In addition, the foreign investor may arrange a tax-free exit by way of a share sale rather than a property sale.

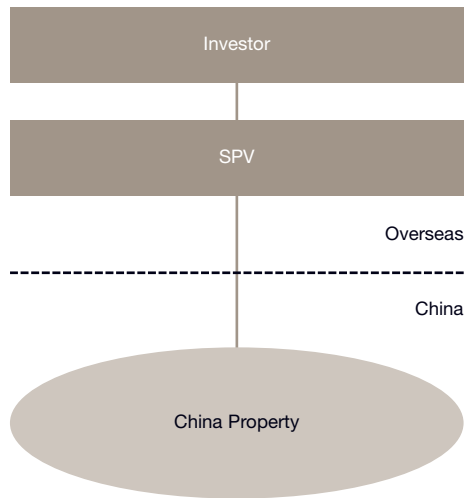
For property development, a foreign investor would have to participate in the project via an FIE in China, as shown in Figure 2.

The FIE would need to stay within a prescribed debt-to-equity ratio which varies depending on the amount of the FIE’s total investment in China. Where the total investment exceeded US\$36 million, the debt-to-equity ratio would be 2:1. The registered capital may not be withdrawn by the foreign investor until the FIE is put into liquidation or an approval to reduce the capital is obtained from the relevant authorities. In light of this restriction, and in a bid to enhance tax efficiency and facilitate cash repatriation, the foreign investor would typically maximise the use of foreign debt to fund the FIE. In this way, the profit can be repatriated by way of

¹ Source: Emerging Trends in Real Estate® Asia Pacific 2007.

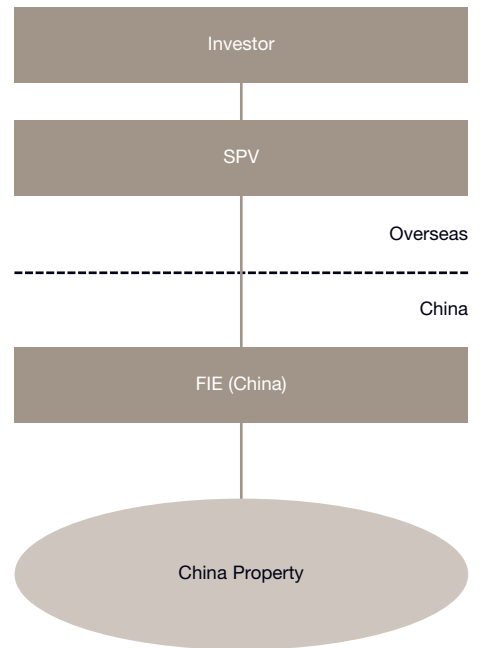
² Source: Emerging Trends in Real Estate® Asia Pacific 2008.

Figure 1



Source: PricewaterhouseCoopers

Figure 2



Source: PricewaterhouseCoopers

interest payment and surplus cash can be repatriated by a repayment of debt.

... things have since changed

On 11 July 2006, six ministries in China³ jointly issued their opinions on the approval and administration of foreign investment in the real estate market. The opinions are set out in the circular Jian Zhu Fang [2006] No. 171 (“Circular 171”). Circular 171 was issued amid what the authorities perceived to be an overheated and highly speculative real estate market, with the aim of regulating real estate investment by foreign investors, real estate development by FIEs, purchase of real estate by foreign entities and individuals, and strengthening supervision.

Among other things, Circular 171 requires a foreign investor to establish an FIE to hold its real estate investment in China. The offshore structure described above (Figure 1) is no longer allowed for new investment, save for limited circumstances. Circular 171 also restricts the maximum debt-to-equity ratio to no more than 1:1 where the total investment of the FIE exceeds US\$10 million, and makes the approval for setting up an FIE conditional upon the FIE paying the land grant price and

obtaining the land use right certificate. Where a foreign investor acquires the equity stake in a domestic Chinese entity or joint venture, it must properly deal with the employees’ issues and bank debts. In addition, the foreign investor must use its own capital to pay all the transfer consideration in one lump sum. In the event that the foreign investor has to form a joint venture with a domestic Chinese entity for real estate investment, the joint venture contract cannot provide any guaranteed returns to the foreign investor.

Circular 171 also stipulates that an FIE engaged in property development cannot obtain domestic or foreign loans if it has not fully paid up the registered capital, has not obtained the land use right, and the injected capital has not reached 35% of the total investment of the project.

... and more to come

After Circular 171, two more important circulars were issued by the Chinese authorities, which impose further restrictions on the structuring of foreign investment in real estate, namely Shang Zi Han [2007] No. 50 (“Circular 50”) and Hui Zong Fa [2007] No. 130 (“Circular 130”).

³ These six ministries are the Ministry of Construction, the Ministry of Commerce, the National Development and Reform Commission, the People’s Bank of China, the State Administration for Industry and Commerce, and the State Administration of Foreign Exchange.



Circular 50 was issued on 23 May 2007 by the Ministry of Commerce (“MOC”) and the State Administration of Foreign Exchange (“SAFE”). It aims to tighten controls on high end real estate projects, investment in domestic enterprises and round-trip structures. It also calls for strict compliance with the requirements for setting up real estate FIEs. More importantly, the set up of FIEs, though approved by the local MOC offices, has to be filed with the Central MOC.

While foreign investors were wondering how the filing requirements may affect them, SAFE issued Circular 130 on 10 July 2007. Under Circular 130, SAFE will not register or convert any foreign debt for real estate FIEs approved on or after 1 June 2007. SAFE will also not register or convert any foreign currencies for capital account items if the filing procedure as mentioned in Circular 50 has not been completed with Central MOC. If strictly enforced, Circular 50 makes it no longer possible for an FIE to be funded by foreign debt, and one would expect delay in forming an FIE and obtaining capital funding for completing a real estate transaction.

How would the changes affect real estate investments today?

One of the major impacts of Circulars 171, 50 and 130 combined is on cash remittances. Now that an FIE is required for property investment or property development in China, and that foreign debt is not allowed to be used to fund the FIE, the FIE may end up with a cash surplus that it may not be able to remit to the foreign investor. This “trapped” cash may result from, for example:

- The depreciation charge which depletes the distributable profits but does not deplete the cash balance;
- The contributions towards the statutorily required profits reserve which deplete the distributable profits but do not deplete the cash balance;
- The recovery of part of the cost of investment via the partial disposal of the property investment or development.

In the past, when the offshore structure was allowed for property investment, the “trapped” cash was not so much an issue. Even where an FIE was used for property development, when foreign debts were allowed, this trapped cash issue could be mitigated through the

It is advisable that the foreign investor should seek to set a sufficiently long completion date and address the situation where the transaction has to be terminated without completion.

repayment of foreign debt to the foreign investor. With the requirement for an FIE and the restriction on the use of foreign debt combined, trapped cash becomes a real issue. The trapped cash may only be remitted to the foreign investor upon liquidation of the FIE or an early reduction in the registered capital. The return on investment would therefore be adversely affected. Meanwhile, it is noted that foreign investors are exploring various means to address the issue, e.g. the use of domestic debt, structured finance products and alternative exit options.

Another major impact of these circulars is the possible delay that a foreign investor may experience in forming an FIE and putting it in a funded position to complete a real estate transaction. In light of this possible delay, in the negotiation of a real estate transaction, it is advisable that the foreign investor should seek to set a sufficiently long completion date and address the situation where the transaction has to be terminated without completion.

Other changes

Apart from the above changes which would affect the structuring of real estate investment in China, other measures have also been introduced

in a bid to cool down the real estate market. The circular Guoshuifa [2006] No. 187 ("Circular 187") concerning the enforcement of collection of Land Value Appreciation Tax ("LVAT") is one of those.

In very general terms, LVAT is a tax imposed on gains arising from the sale of immovable property, and the tax rates range from 30% to 60%. In the past, a tactic widely practised in the property development industry was to seek to postpone the payment of the full amount of LVAT. An FIE may have to pay a "provisional" LVAT based on a certain percentage (e.g. 1%) on the sale proceeds of the property units, but would typically leave a very small number of property units unsold to avoid the LVAT clearance and payment of the full amount of LVAT. On 28 December 2006, the State Administration of Taxation ("SAT") issued Circular 187. Among other things, the circular urges the local tax authorities to strictly enforce collection of LVAT. The SAT sets out various conditions in the circular under which LVAT clearance must be performed. For example, an FIE has to perform LVAT clearance where more than 85% of the saleable area is sold, or the sale or pre-sale permit has been issued for more than three years although the



sales have not been completed. Circular 187 has understandably been met with resistance from the industry and it is yet to be seen how the local authorities may implement the circular in practice.

The new Corporate Income Tax Law and double tax agreements

Foreign investors should also be aware of the new Corporate Income Tax ("CIT") Law that will take effect on 1 January 2008. The new CIT Law will unify and replace the two sets of existing tax laws that separately apply to domestic enterprises and FIEs. It is a milestone in the modernisation of the tax system in China.

The new CIT Law was passed by the National People's Congress on 16 March 2007 and provides a framework of the new tax regime. Important details, definitions of terms, interpretation and application are to be provided in the detailed implementation rules ("DIRs") which have yet to be finalised. According to the new CIT Law and the current draft DIRs (as of 17 October 2007), the current standard corporate income tax rate of 33% will be reduced to 25% under the new law; whereas the current withholding tax exemption applicable to dividends will

be uplifted and a 10% dividend withholding tax will be imposed. Such dividend withholding tax may, however, be reduced by an applicable double tax agreement ("DTA").

With the introduction of dividend withholding tax under the new CIT Law, foreign investors may seek to access DTA protection for a reduction. In recent years, many foreign investors have sought to access the Barbados-China DTA. The beauty of the China-Barbados DTA is that it affords protection from China income tax in respect of gains arising from disposal of Chinese companies. This is the case irrespective of whether the principal assets of the Chinese companies consist of immovable properties or not. The DTA also contains the China withholding tax rate for dividends to no more than 5%. Notwithstanding these DTA benefits, some investors may find it inconvenient to maintain an entity in Barbados. There have also been rumours in the market that the Chinese authorities have sought to re-negotiate the DTA with Barbados, and such re-negotiation may result in certain DTA benefits being removed.

Meanwhile, Hong Kong recently concluded a comprehensive DTA with mainland China in August 2006.

Foreign investors should assess the possible impact of the new CIT Law on their investments in China.

The treaty has taken effect in mainland China since 1 January 2007. Under the DTA, the China dividend withholding tax is contained to no more than 5% if the Hong Kong entity holds no less than 25% equity interest in the Chinese entity, and interest withholding tax to no more than 7%. Given these DTA benefits and its proximity to China, Hong Kong has emerged as a popular jurisdiction for companies to be set up for holding investment in mainland China. It should, however, be noted that the DTA does not afford protection in respect of gains arising from disposal of a Chinese company where the principal assets of the Chinese company consist of immovable properties.

Another feature of the Hong Kong DTA with mainland China is that it provides protection in respect of income from certain services performed in China. If the services are rendered in China within a period or periods which in aggregate do not exceed the time period stipulated in the DTA, the related income would not be subject to China income tax. It is however important to note that the mainland China authorities have their own interpretation of the stipulated time period, which may be seen to be very different from the layman's interpretation of the DTA.

Foreign investors should be cautious not to fall within the tax net in mainland China inadvertently when managing their real estate investments there.

The new CIT Law also contains various provisions commonly seen in the Western tax legislation, such as controlled foreign corporations, thin capitalisation, transfer pricing and anti-avoidance rules. Foreign investors should assess the possible impact of the new CIT Law on their investments in China.

Conclusion

Despite the various changes to the regulations and tax regime in China in the recent past, it would appear that foreign investors have remained very interested in the real estate market in China. While the real estate market continues to prosper, competition has stayed stiff. To be successful in this market, foreign investors have to keep abreast of the changes and adjust their strategies as appropriate.

Foreign investments in the real estate sector: Tax and regulatory overview

India, with its burgeoning population has always faced a need for increased housing. There is huge demand amongst middle-class families for housing facilities. Increased per capita income and the availability of cheap housing loans fuelled by a booming Indian economy are further driving factors.

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Also, with many foreign companies entering into India to capitalise on the business opportunities in a booming economy, the demand for commercial space (primarily spurred by industries such as IT and IT-enabled services, retail and hospitality) has also touched the roof. Commercial property rates at prime spaces and real estate deals are reaching record highs.

The existing infrastructure facilities are immensely burdened and need to keep pace with the rapid globalisation of the Indian economy.

The various regulators in India [the Department of Industrial Policy and Promotion ('DIPP'), the Securities & Exchange Board of India ('SEBI') and the Reserve Bank of India ('RBI')] are faced with a difficult challenge: to attract foreign investment and at the same time check speculation in the booming real estate sector.

This article gives a brief overview of the tax and regulatory framework governing foreign investment in the Indian real estate sector and the key challenges faced by a foreign investor while structuring investments in Indian real estate companies.

Routes for foreign investment

India prohibits direct foreign investment in real estate property, except on investments by non-resident Indians ("NRIs"). Foreign investment has to be made through Indian real estate companies.

Foreign investments in India could typically flow under the following routes:

1. Foreign Direct Investment ('FDI') route

FDI in real estate companies is governed by the conditions of Press Note No. 2 (2005 series) issued by DIPP. Under the Press Note, FDI is permitted in Indian real estate companies only for undertaking construction development projects (housing, commercial premises, hotels, resorts, etc).

The Press Note specifies various conditions to be complied with, such as the minimum area to be developed, minimum capitalisation norms, a three-year lock-in period for foreign investment, compliance with regulations of the respective state government/municipality, etc.

The Ministry is in the process of issuing Frequently Asked Questions to clarify the various issues under the Press Note.

There are a number of interpretive issues surrounding the applicability of the conditions under the Press Note in various circumstances. The Ministry is in the process of issuing Frequently Asked Questions to clarify the various issues under the Press Note.

Further, the conditions of the Press Note are inapplicable to investments in Indian companies engaged in the following activities:

- Setting up of industrial parks/ Special Economic Zones ('SEZ'); and
- Establishment and operation of hotels.

2. Foreign Institutional Investment ('FII') route

FII investments are undertaken under the Portfolio Investment Scheme. Hitherto, this route was meant for portfolio investments in Indian listed companies on the stock exchange. However, the regulations have since been liberalised to allow investments in unlisted companies.

The conditions under Press Note No. 2 are inapplicable to FIIs. There is an ongoing tussle between the various ministries and regulators as to whether

a lock-in should be prescribed for FII investment in pre-IPO deals. This issue is yet to be ironed out.

Further, there are restrictions on the maximum investment that can be undertaken by an FII in a single company. The maximum investment allowed by each FII is 10% of the share capital of the company.

There is also an overall restriction of 24% on aggregate FII investment in a single company, which can be increased by the Indian company up to the sectoral cap. There is presently a doubt on whether an Indian company engaged in non-FDI-compliant projects can increase the limit beyond 24%.

3. Foreign Venture Capital Investment ('FVCI') route

The FVCI route is another possible route for foreign investments in unlisted companies in India. The earlier restriction on investment in the real estate sector by FVCI was removed by SEBI.

However, to check unrestricted foreign inflows in the Indian sector in non-FDI-compliant projects, the RBI has kept on hold all applications for FVCIs contemplating investments in the real estate sector.



4. External Commercial Borrowings ('ECB') route

The ECB route was another route under which foreign borrowings were permitted for integrated township projects until recently. The RBI has, however, closed this route by placing a blanket prohibition on any investment in real estate companies.

However, ECB is allowed in certain specified infrastructure facilities (such as industrial parks). Further, ECBs are also subject to various other stringent conditions such as eligible borrower, recognised lender, average maturity period, all-in-cost-ceilings, cap on rupee expenditure, etc.

The tightening of the regulatory framework for the real estate sector amidst substantial liberalisation of exchange control regulations (towards full capital convertibility) clearly points out the sensitivity with which Indian regulators are dealing with this sector. This poses significant challenges for foreign investors in structuring their investments in an Indian real estate company, some of which are dealt with in the ensuing paragraphs.

Instruments for undertaking investment

Until now, investments were permissible in equity shares, preference shares and convertible debentures. This provided some flexibility to foreign investors for structuring their investments based on their commercials.

However, recently, to curb usage of the FDI route for effective borrowing, DIPP and RBI has mandated that all investments in India by way of preference shares and convertible debentures need to be compulsorily convertible into equity within a specified period; otherwise such investments would be treated as ECBs. Accordingly, under the FDI route, the following funding options are available:

1. Equity shares;
2. Compulsorily convertible preference shares ('CCPS'); and
3. Compulsorily convertible debentures ('CCD').

Each funding option has its own implications and the optimum option or a mix of various instruments needs to be chosen dependent upon the commercials of the project.

Some recent court decisions have observed that CCD being compulsorily convertible into equity is effective equity even before conversion.

Capital structuring

The Indian company law places various restrictions and conditions on repatriation of capital. Considering the commercials of any given structure, it is critical to design the capital structure appropriately to enable timely repatriation by the foreign investor in a tax efficient and regulatory compliant manner.

The following are the various modes of repatriation available to the foreign investors:

1. Interest on CCD

Presently, in India, there are no thin capitalisation norms. Therefore, structuring the investment by way of CCD (also called mezzanine financing) offers an opportunity for an Indian company to benefit from tax breaks at 33.99% (the maximum rate) and taxation in the hands of the foreign company at lower rates, if the investor is a resident of a tax-efficient investment jurisdiction.

However, some recent court decisions have observed that CCD being compulsorily convertible into equity is effective equity even before conversion. A specific ruling of the higher courts or a suitable clarification is needed to do away with the controversy surrounding

this issue so that interest can be claimed deductible by the Indian company.

Further, in the case that the foreign investor and the Indian company are treated as Associated Enterprises, such interest should be at an arm's length pricing.

2. Dividends on shares

Under the Indian exchange control regulations, dividends on CCPS can be paid up to the Prime Lending rate of the State Bank of India plus 300 basis points (presently this works out to 15.75%). However, no cap is specified on dividends on equity shares.

Indian Company law requires dividends to be declared only out of profits and after prescribed transfer to reserves. Dividend Distribution Tax ('DDT') is applicable in the hands of the Indian company at 16.995% on the dividend amount. Such dividends are, however, exempt in the hands of the shareholder.

3. Buy-back of shares

Under Indian company law, an Indian company is permitted to undertake buy-back of shares subject to various conditions. Buy-back is permitted only out of specified sources (i.e., free reserves, securities premium

and fresh issue of shares of a different kind).

The Exchange Control regulations also allow buy-back of shares under the automatic route subject to compliance with documentation, pricing and reporting norms.

Gains arising on buy-back of shares are treated as capital gains in the hands of the investor. In the case that the shares are held by a company resident in a tax-efficient jurisdiction, such capital gains could become non-taxable in India.

Company law also allows issue of equity shares with differential rights. This offers an innovative structuring opportunity whereby shares are issued with differential rights to the foreign investor and the Indian developer.

It is critical to design the capital structure in a manner that maximum monies could be repatriated by the foreign investor by undertaking buy-back of shares considering the various conditions on buy-back under Indian company law and the pricing norms under the Exchange Control regulations.

4. Sale to promoters/third party

Sale to promoters/third parties is another mode of repatriation of capital. In the case that the shares are held by a company resident in a tax-efficient jurisdiction, such capital gains could become non-taxable in India.

In the case of exit by sale to Indian residents, it is critical to ensure compliance with the applicable pricing norms under the Exchange Control regulations.

5. Capital reduction/liquidation of the company

Capital reduction/liquidation are other ways under company law by which repatriation could be undertaken. Both require court approval.

Any gains on capital reduction/liquidation could, however, be treated as dividends to the extent of accumulated profits of the Indian company, leading to a DDT implication in the hands of the Indian company.

Promote structures

Generally, in India, the local developers possess the expertise and land, while

foreign investors contribute the capital. In such cases, foreign investors generally agree a preferred waterfall structure (also called promote structures), whereby they mandate a preferential payment of capital and pre-agreed IRR. Once this is achieved, the Indian developer gets a preference on the remaining profits of the project.

It is critical to structure the arrangements appropriately through use of differential rights shares/convertible instruments to ensure that the commercially agreed waterfalls are achieved.

Jurisdictions for foreign investments in India

To achieve tax efficiency in the hands of the foreign investors, it is important that the investment is structured through a tax-efficient investment jurisdiction.

The key jurisdictions preferred for inbound investments in India are Mauritius, Singapore and Cyprus.

1. Mauritius

Mauritius is the preferred jurisdiction for investments in shares of Indian companies, it being blessed by the Apex Court in Azadi Bachao Andolan's case. However, recent high level delegation meets between the officials of the two countries, followed by the strengthening of the norms relating to the issue of Tax Residency Certificates in Mauritius, do give rise to the possibility of a future re-negotiation of the Tax Treaty. Introduction of anti-abuse Treaty provisions in the domestic income tax law also cannot be ruled out.

2. Singapore

Singapore is another jurisdiction, under the Treaty, in which capital gains earned by a Singapore resident are not taxable in India. However, the Treaty provides for a limitation of benefits clause, whereby a company set up with the prime objective of availing Treaty benefits is not eligible to take advantage of the Treaty benefits. Also, there is a controversy in Singapore on the characterisation of income of investment companies as business income or capital gains. Further, the protocol to the Singapore Treaty also states that the capital gains

The concept of beneficial ownership under the Treaties entered into by India is largely untested and hence the interpretation is guided by general law and international precedents in this respect.

tax exemption under the Treaty will remain in force so long as the Mauritius Tax Treaty is not amended. Foreign investors therefore generally prefer Mauritius over Singapore as a tax-efficient investment jurisdiction.

3. Cyprus

Another possible jurisdiction is Cyprus, which is similar to Mauritius and exempts capital gains under the Treaty. At the same time, there is no limitation of benefits clause under the Treaty. Further, while interest is taxable under the India-Mauritius Tax Treaty at the local Indian tax rates (except in the case of Mauritius banks), interest under the Cyprus Tax Treaty is taxed at a beneficial rate of 10% on a gross basis. One of the conditions for availing this rate is that the recipient should be the beneficial owner of such interest. The concept of beneficial ownership under the Treaties entered into by India is largely untested and hence the interpretation is guided by general law and international precedents in this respect.

Tax incentives for real estate

Like many emerging economies, India offers a host of tax incentives for specified real estate activities, some of which are summarised below:

1. Infrastructure facility

- Developing or operating and maintaining or developing, maintaining and operating any infrastructure facility.
- Infrastructure facility is defined to mean Roads, Bridges, Rail System, Highway Projects including housing or other activities being integral part thereof, Port, Airport etc.
- 100% of profits eligible for deduction for 10 out of 15/20 years subject to conditions.

2. Industrial Parks

- Developing, or developing and operating or maintaining and operating an industrial park.
- Business to commence before 31 March 2009.
- 100% of profits eligible for deduction for 10 out of 15 years subject to conditions.

3. Housing projects

- Developing and building housing projects approved by local authority before 31 March 2007.
- 100% of profits derived from such projects eligible for deduction subject to certain stringent conditions.



4. SEZ

- Developing SEZ notified on or after 1 April 2005 under the SEZ Act.
- 100% of profits for 10 years out of 15 years eligible for deduction
 - Minimum Alternate Tax inapplicable
 - Dividends out of current income exempt from DDT.
- SEZ Act and SEZ Rules to be complied.

5. Hotels and convention centers

- Hotel business or building, owning and operating a convention centre located in specified area (Delhi and specified adjoining districts).
- Hotel to be constructed and start functioning and convention centre to be constructed between 1 April 2007 and 31 March 2010.
- 100% of profits eligible for deduction for five years subject to conditions.

Other issues

Apart from the above, foreign investment in Indian companies also faces issues similar to those applicable to any private equity investor investing in India.

Some of the issues relate to:

1. Characterisation of gains (business income v. capital gains);
2. Permanent Establishment issues;
3. Substance issues;
4. Structuring the overseas management company and the Indian advisory company; etc.

Each of the above requires appropriate structuring to mitigate tax risks in India.

Structuring is critical

The fast-growing real estate sector has tremendous opportunities to offer to foreign investors. However, this industry is also subject to various challenges, especially in light of the various developments on the tax and regulatory front.

Each real estate investment has its own challenges in terms of securing the interests of the foreign investor as well as the local Indian developer (in the case of a joint venture). It is critical to ensure that investment by foreign investors is structured appropriately from a tax and regulatory perspective to realise the full benefits from their investments.

Recent corporate taxation developments in Singapore

Singapore has long been a key regional financial centre. In recent times, one of the main growth areas has been the investment management industry. This is a direct result of the Singapore Government's continuous effort of promoting the industry through various means, including the use of tax incentive schemes.

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The 2007 Budget was presented by the Singapore Government in February 2007. There was considerable excitement generated in the investment management industry in Singapore due to the significance of some of the announcements, such as the removal of the infamous "80:20 rule" under the tax exemption scheme for offshore funds managed in Singapore. Details of the much-awaited framework to replace the 80:20 rule were provided by the Government in a circular dated 31 August 2007 ("the circular").

New framework replacing the 80:20 rule

Under Singapore's tax exemption scheme for offshore funds managed in Singapore, it was previously a requirement that not more than 20% of the offshore fund was held by Singapore citizens or residents (i.e. the 80:20 rule). This resulted in compliance issues for fund managers managing offshore funds in Singapore and created uncertainty in terms of the taxability of those offshore funds.

The new framework replacing the 80:20 rule that is set out in the circular applies to funds existing before 1 September 2007 as well as those set up thereafter. For the former, there is an option of applying the new framework from 1 September 2007 or from the next financial year beginning on or after 1 September 2007.

On the whole, the new framework should help alleviate some of the compliance issues and uncertainty previously faced by fund managers in Singapore. To a certain extent, the new framework will also facilitate access to funds of Singapore investors for Singapore fund managers. Nonetheless, some areas of the new framework will have to be clarified in order to facilitate its implementation.

Broadly speaking, a qualifying fund will now be granted tax exemption at the fund level, regardless of the residency status of its investors. This is so provided it is not 100% owned by Singapore investors. Tax, if any, will be collected from the investor depending on his specific profile.

The key distinguishing features between the old and new regime are as follows:

- A fund that is more than 20% held by Singapore investors can now have access to the tax exemption scheme that was previously only available to funds that met the 80:20 rule.



- The new framework still carries conditions, but unlike the 80:20 rule, the conditions under the new framework are more within the control of the fund manager. For example, under the new rules, a qualifying fund in the context of a company is defined as a company that is not resident in Singapore and which is not 100% owned by investors in Singapore, and the company does not have a Singapore presence or business activity (other than a fund manager).
- The new framework separates investors of a qualifying fund into two categories – qualifying and non-qualifying. If the fund has any non-qualifying investors, such investors will be required to account for a “quasi” tax (known as the “financial amount”) on their share of the fund’s profits, without affecting the tax-exempt status of the fund or the qualifying investors. The interesting point to note is that where the fund is not resident in Singapore, a non-qualifying investor will potentially be “taxed” twice. This is because, according to the circular, he will pay the financial amount, but will also be subject to normal tax rules when he receives his distribution from the fund in Singapore. There is

no basis for a credit for this financial amount against his actual tax. Whether this was intentional or an oversight is not clear. But what is clear is that it gives the approved Singapore resident fund a serious leg-up, as a result of its ability to pay exempt dividends (see below).

- To implement the collection of the financial amount, certain reporting requirements have been imposed on the fund manager and non-qualifying investors.

Finally, it has been clarified that the above changes will also apply to approved Singapore-resident fund companies. This is an enhancement from what was stated in the Budget speech in February this year. This is a welcome announcement since it puts Singapore domiciled funds on an equal (or even advantaged) footing with their offshore counterparts.

Conclusion

All in all, we think the changes are a step in the right direction and in line with expectations. Of course, there are areas which would require further clarification to facilitate smooth implementation of the new rules.

QDII: An interim solution for Chinese domestic investors

Qualified Domestic Institutional Investors (“QDII”) represents an interim solution for Chinese domestic investors to gain access to the foreign markets at a time when the country’s currency is not freely convertible and when domestic capital is not allowed to move across the territory.

Rex Chan

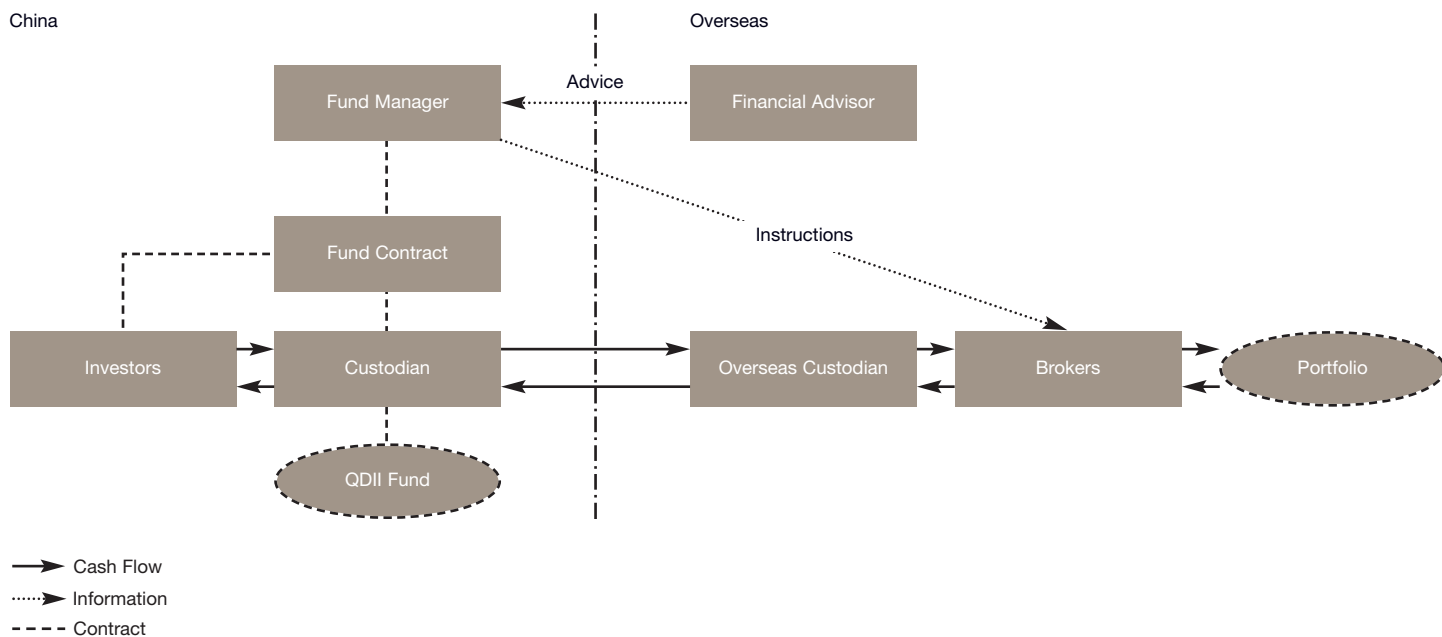
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On 13 April 2006, the People’s Bank of China (“PBOC”) issued a notice allowing investors to invest in overseas markets via certain approved banks, insurance companies, fund management companies and other asset management institutions. This has marked the start of QDII in China. As pioneers, some commercial banks were initially allowed to offer offshore-investment-based wealth management products to domestic institutional and individual investors. However, the QDII investment was limited to fixed income products. This limitation resulted in a much lower return as compared to investing in the domestic stock markets. The QDII products looked very unattractive. It was reported that an aggregate quota of US\$12.6 billion has been allotted to the approved QDII operators, yet only US\$300 million, or approximately 2.4%, was utilized up to May 2007.

Regulatory bodies then issued a series of regulations to boost the QDII scheme. The first one came from the Interim Administrative Measures for Trust Companies to Provide Overseas Wealth Management Trust Services issued by China Banking Regulatory Commission (“CBRC”), which introduced trust companies as a new type of QDII players. On 10 May 2007, CBRC announced that with certain restrictions, banks can now offer stocks-related products. On 18 June 2007, the China Securities Regulatory Commission released the long-awaited Tentative Procedures for the Administration of Overseas Securities Investments by Qualified Domestic Institutional Investors for fund management companies and securities companies. Ten days later, the China Insurance Regulatory Commission issued QDII rules for insurance companies.

Market reactions to the above administrative measures seemed positive. A CBRC official speculated at the end of May 2007 that Chinese banks will increase the amount of client money invested abroad from the then US\$800-900 million to several billion US dollars. On 14 September 2007, China Southern Fund Management Company’s global stock investment fund has attracted an estimated

Figure 1



Source: PricewaterhouseCoopers

total subscription of RMB 40 billion to 50 billion yuan (US\$5.3-6.7 billion), much more than the RMB 15 billion yuan that the firm was allowed to raise. Several other fund managers' QDII products are in the queue, including China Asset Management Company (US\$2.5 billion in quota) and Harvest Fund Management Company. As the first securities dealer having acquired the QDII license, China International Capital Corporation (CICC) plans to raise US\$1 billion for its QDII products.

A typical QDII fund structure is illustrated above (Figure 1).

One of the difficult challenges that QDII fund managers must face is the ability to identify and manage risks in the overseas markets. As newcomers, they should be cautious that "the water out there is deep". The current global financial market turmoil caused by the US sub-prime crisis is a recent example to demonstrate the volatility of the market. Since QDII products may invest in multiple overseas markets and the regulatory environments vary from one to the other, the risks could be

difficult to manage in areas such as exchange rates, foreign exchange control, taxation, regulatory issues and political risk. Taking taxation as an example, different tax implications, including withholding tax on dividends, interests and capital gains will affect the final return of the investments. Moreover, some business activities carried out in the target investment countries may create a permanent establishment in the country and hence expose the entire investment to the target country's tax net. Looking back to China, the current tax regulations on trust and funds are still largely unclear. Fund managers or custodians need to consider whether they have obligations to withhold tax from the distribution to the domestic investors. As the underlying investor, one has to ascertain whether earnings from QDII products would be subject to China tax and if so, whether and how the investor can claim a credit on foreign taxes paid.

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