

Asia Pacific Private Equity Tax*

March 2009



Welcome to the inaugural issue of Asia Pacific Private Equity Tax.

Our journal is designed as an annual review of taxation issues affecting private equity firms and their investors in the Asia Pacific region.

A broad range of specialist authors have provided insights into some of the many tax issues and opportunities that private equity firms and their investors will consider over the coming year; as well as an update on key tax developments for the industry in the region.

Please feel free to contact any of the specialist authors listed, our country leaders or your regular PwC contacts to discuss any of the topical issues and country updates profiled.

I do hope you enjoy our review and wish all our clients, colleagues and friends the very best returns for 2009.

Stuart Porter
Asia Pacific Private Equity Tax Leader
PricewaterhouseCoopers

+81 3 5251 2944 (direct)
+81 80 1145 3474 (mobile)
stuart.porter@jp.pwc.com

Agenda

Topical issues

- 03 **The state of the private equity market in the Asia Pacific region**
Charles Humphrey
- 05 **Vendor due diligence**
Mark O'Reilly, Sean Keegan
- 07 **Carried interest planning**
Darren Docker, Marianne Edwards
- 10 **Islamic and Shariah compliant private equity funds**
Jennifer Chang, Charlini Yogeswaran
- 12 **Challenges for Asia Pacific regional based fund managers: lessons from China**
Terry Tam, Rex Chan, David Kan
- 17 **Tax examiners at the gate: the rise of transfer pricing**
Ryann Thomas, Dhaivat Anjaria, Shyamala Vyravipillai, Mac Calva
- 23 **Effective tax planning to enhance cash flow for portfolio companies**
Chris Woo, Sarah Wong

Country updates

- 27 **China – Investing through RMB funds**
Danny Po, Jeremy Ngai
- 30 **India – Key recent tax and regulatory developments concerning private equity investments**
Punit Shah, Himanshu Mandavia
- 33 **Japan – Rolling back the clock – proposed reforms to the taxation of private equity in Japan**
Akemi Kito, Marc Lim
- 37 **Taiwan – An expensive price to pay: mis-managing your tax position**
Elaine Hsieh, Chun-Chih Tseng, Eric Chen

Country contact list

PricewaterhouseCoopers Asia Pacific Private Equity Tax is an annual publication that offers an insight into topical tax issues, trends and developments in the private equity industry in the Asia Pacific region.

If you would like to discuss further any of the issues raised, please contact the individual authors or the country contacts listed at the back of this publication.

The state of the private equity market in the Asia Pacific region

Challenging market conditions across the globe have had a direct impact on private equity (**PE**) deal flow across the Asia Pacific region, however the timing of the impact has differed; with Australia experiencing the downturn in activity nearly 12 months ago, whilst China only slowed down in the fourth quarter of 2008. Over the next 12 to 18 months, we are expecting on average fewer deals, fewer exits, longer hold periods and lower deal sizes; but fit and agile PE funds will still capitalise on some exceptional value situations, and even those in a weaker investing position will be able to create sustainable value in their portfolio companies.

Despite three consecutive quarters of growth, mergers and acquisition (**M&A**) activity in Asia (excluding Japan) in 2008 fell by 11.1% to US\$387.8 billion. Fourth quarter deal making volume totalled US\$71.3 billion, a 45.5% drop from the all time high of US\$130.7 billion recorded in the fourth quarter of 2007. This reflects the continuing constrained credit availability which is limiting corporate and PE ability to take up new deals. In Japan deal volume decreased by 3.8%.

It's worth noting that M&A activity in China remained strong, with deal volumes increasing by 44% to US\$159.6 billion. In fact towards the end of 2008, China was the only country in the region to experience growth in such a tumultuous economic environment. There was a 68% decline in new global PE fund commitments

between Q1 and Q4 2008 (but off a significantly higher FY07 base), and this is likely to decline further in 2009.

Given this, PE funds will refocus on recapitalisation and restructuring of existing portfolio investments to preserve value. Financiers and equity investors are becoming increasingly intolerant in their attitude to deteriorating businesses under financial and operating stress, and PE funds are being increasingly pro-active in sharing strategic plans with financiers to support the stabilisation initiatives being implemented at their portfolio investments.

There may be a need for equity top-ups and in some situations, where there is limited headroom of uncalled commitments, PE funds have arranged additional funding facilities to enable additional investments required to stabilise portfolio companies.

Capital market valuation pressures and lower earnings before interest, tax depreciation and amortisation (**EBITDA**) due to cutbacks in consumer spend and the flow through impact of financial crisis into the real economy, will inevitably result in hold periods extending into 2010 and possibly 2011 on existing portfolio investments.

Funds will have to make difficult decisions around the longevity of their portfolio investments, they may even have to allow them to fail, a few well-known investments will not survive in 2009.

But it is **not** all bad news. There is an undercurrent of optimism and a sense that savvy PE firms will thrive by taking advantage of opportunities to diversify into value investments in "new" sectors such as investment management, property, insurance, infrastructure and resources. These sectors have been adversely affected by the global downturn and sellers' price expectations are coming down and are expected to decline further.

Activity in the buyout community will nevertheless take a back seat, with PE fund focus remaining firmly on preserving value in existing portfolios. Short term strategic business reviews, cash optimisation initiatives, and strategic option scenario analyses are taking hold and are critical to portfolio companies implementing quick wins to stabilise their performance and restore stakeholder confidence.

In terms of deals, PE funds will contribute more equity to deals and complete a higher proportion of non-controlling investments and bolt on deals in late 2009/mid 2010 where they will not need to raise new debt. The non-controlling investments will be regeared and PE funds will move to control when debt markets recover in 18 months time.

Conclusion

In 2009 PE will focus on stabilising its portfolio investments so as to be in a strong position when the market returns to more normal investment patterns. Despite a slow year, deal flow will bounce back strongly by mid 2010, however, these deals may be fundamentally different with more minority stakes, more partnerships with incumbent owners, more co-investments with sovereign wealth funds, other major limited partners and corporates. Those PE funds who adapt to the new investment paradigm will inevitably thrive in the new economy.



Charles Humphrey
Partner

Transaction Services

PricewaterhouseCoopers
Australia

+61 2 8266 2998
charles.humphrey@au.pwc.com

Charles is a partner in our Transaction Services practice and heads our Asia Pacific Private Equity practice. He has over 23 years experience in conducting due diligence engagements and providing valuation advice on major merger and acquisition transactions domestically and abroad.

Sources:

- UBS report: Financial sponsor activity in Australia, January 2009
- The Carlyle Group: How the Global Credit Meltdown has changed the world of private equity for the better, February 25, 2009
- Thomson Reuters: Mergers & acquisitions review, fourth quarter 2008
- Dow Jones: Private Equity Analyst Outlook 2009

Vendor due diligence

The purpose of conducting a due diligence is to gather information and identify significant risks associated with a target business or asset. It can also provide a purchaser with a list of opportunities to pursue if the acquisition takes place. Traditionally, the due diligence process has been initiated by the potential purchaser with a view to evaluating these risks, but increasingly, vendor due diligence is becoming a common feature of M&A transactions across Australasia.

Vendor due diligence is a process by which the vendor and its advisers undertake a detailed review of the business that the vendor is proposing to sell. Essentially, the vendor conducts a due diligence on its own business of a type the potential purchaser is expected to undertake.

The vendor due diligence report attempts to address the concerns and issues that may be relevant to any prospective purchaser. Vendor due diligence reports can include commercial, legal, financial, and tax aspects of the business. The aim of the vendor due diligence report is to bring together all of the information regarding the business that any potential purchaser would require if it was performing its own due diligence.

Any costs of conducting the vendor due diligence are usually borne by the vendor, although a vendor may attempt to pass these costs on to any successful purchaser.

A vendor due diligence has many advantages both for the vendor, and also the potential purchaser. These include:

- The vendor due diligence report gives bidders the information they require in an easy to read document, and can also serve as a useful summary of the information contained in the data room.
- One of the reasons a transaction can collapse is that the investigative process takes too long. Where there is a significant delay in conducting its due diligence, a potential purchaser may decide to pursue other transactions or consider that there are other uncovered risks that could result in the transaction failing. Conducting a vendor due diligence may speed up the sale process and ensure a successful transaction.
- It is important to understand that a vendor due diligence is unlikely to satisfy all of the buyer's needs because the potential purchaser may have reasons for purchasing the business which are not contemplated in a vendor due diligence (such as possible synergies with the target business). As such, whilst a vendor due diligence report does not replace a buyer's due diligence, it should reduce the amount of due diligence on the business that a buyer wishes to undertake.
- Vendor due diligence can save potential purchasers spending significant amounts of money with no certainty of a successful outcome. This could mean more bidders at the beginning of the transaction.
- A vendor due diligence may also eliminate the duplication of due diligence work by multiple buyers who want answers to many of the same questions. This ensures that any disruption to existing management and the continuing day to day running of the business is minimised.
- Where a potential purchaser uncovers risks in the business during a due diligence process, the purchaser will usually seek to reduce the purchase price to compensate for the additional risk. The undertaking of a vendor due diligence allows the vendor to detect any issues existing prior to sale which may have a material effect on the purchase price. This can provide the vendor an opportunity to rectify these issues prior to sale and reduce the scope for the purchaser to negotiate a price reduction.

Despite the advantages of conducting a vendor due diligence outlined above, there are some important issues that the vendor, the vendor's advisers and any potential purchaser must consider:

- Before beginning a vendor due diligence, it is important that the vendor and the adviser agree on a clear scope and the information to be contained in the due diligence report. The agreed scope of work is important as a potential purchaser may not place much reliance on a vendor due diligence if the report does not address the purchaser's significant potential concerns.
- Prior to beginning the vendor due diligence, it is important to determine the extent to which a potential purchaser can rely on a vendor due diligence report. A report may be prepared on an information only but no reliance basis or on a full reliance or partial reliance basis. Where a purchaser is not entitled to rely on the report, it may need to conduct a more detailed due diligence to confirm the findings in the vendor due diligence report.
- For the vendor's advisers, there are potential conflicts of interest and professional liability risk issues involved when preparing a vendor due diligence report, which although they can be overcome, may reduce the usefulness of the report.

The above issues may limit the effectiveness of the vendor due diligence report, and should be considered carefully by the vendor and purchaser when undertaking a transaction in which a vendor due diligence has been performed.



Mark O'Reilly
Partner

M&A Tax

PricewaterhouseCoopers
Australia

+61 2 8266 2979
mark.oreilly@au.pwc.com



Sean Keegan
Manager

M&A Tax

PricewaterhouseCoopers
Australia

+61 2 8266 4484
sean.keegan@au.pwc.com

Mark and Sean both work in the M&A tax group. In this group, they provide taxation advice on financing, international and domestic structuring, mergers and acquisition transactions including due diligence transactions.

Carried interest planning

As the turmoil in the international markets continues and uncertainty abounds, incentivising fund managers in a tax efficient manner becomes increasingly important to individual managers, their employers, and the private equity (PE) houses, alike.

A common method used widely in the United States and Europe over the past few decades is to have a carry plan in place for key executives. However, despite the many benefits of such a plan, carry plans may be less familiar to readers in the Asia Pacific region at present. This article outlines the benefits of such a plan, how it might be treated for tax purposes in various jurisdictions and other considerations that should be taken into account.

It is interesting to note that, following a high level of scrutiny in Europe and the U.S., particularly at present following the announcement of the Obama administration that carried interest will be taxed in future as ordinary income at the highest rate of federal tax, the position of tax authorities in the Asia Pacific region on the tax treatment of carried interest is largely uncertain. Whether this will change in future years is yet to be seen and it may ultimately be a function of how the PE industry will weather the global recessionary storm.

Towards the end of 2008 there were several high profile instances of large fund managers either publicly appealing to limited partners not to

default on their commitments, or negotiating down the size of funds closed a number of years earlier. One feels that to the extent the industry is smaller, and hence less high profile, the less potentially intense will be the attention it attracts from policy makers when they are setting tax policies. As such, any guidance or changes in existing policy concerning the treatment of carried interest may not be forthcoming.

What is a carried interest plan?

Within a traditional fund structure, key individuals, who are employees or directors of the PE fund management company or an associated company could be invited to join the carried interest plan. The plan essentially works by those individuals contributing a nominal amount of capital to the fund, typically structured as a limited partnership, and hence becoming partners in the limited partnership. Participation in such a plan would be in addition to the executive's remuneration from a salary and bonus.

Payment of carried interest from the fund to the individual participants in the plan (typically 20% of profits of the fund above a threshold) arises on realisations of investments in portfolio companies, and is subordinate to a return of investors' capital either on a whole fund basis or a "deal by deal" basis, and an agreed rate of return. Consequently only in cases where investments are sold by the fund with a substantial gain may carried interest

holders realise a significant amount of carried interest.

The potential upside of carry is often balanced against the material investment in the fund that carry holders are usually required to undertake (**Co-investment**). The PE executives typically invest directly into the Co-investment vehicle using their own wealth or bank loans. The Co-investment vehicle is required to take a proportionate stake in all investments of the fund, and co-investors are fully exposed to all gains or losses made by the Co-investment vehicle. Unlike the fund, the Co-investment vehicle would not typically be required to pay management fees or carried interest.

Often, Co-investment and carried interest are commercially viewed, and legally structured, as a unified investment by executives in the fund. It is worthy of note (and has been pointed out by national PE industry representative bodies to legislators) that the executive, being an individual, takes a far greater risk than the fund's institutional investors. Whilst institutional investors invest a small proportion of their total assets in one fund, a PE executive is required to invest a substantial portion of his personal net worth, often more than a year's salary and bonus.

The risk can be illustrated by data of the British Venture Capital Association in respect of UK PE funds, which shows that roughly half of all funds do not pay carried interest and, moreover,

one in four funds loses money. In today's climate this is an important consideration for anyone considering participating in such a plan.

Why implement a carry plan?

A carried investment plan aligns the fund managers' interests to that of the investors by allowing them to benefit from the growth in value of the fund partnership once any preferred returns have been paid to the investors. The PE executives will continue to receive their standard salary alongside any Co-investment profits, but the carry plan could be used to replace their bonus plan, or complement it.

As a hurdle rate must be reached before any payments are made, in a "normal" economic environment, it can take 3 – 4 years before the PE executives receive a carry payout from the fund. This proves useful in "handcuffing" good executives to a fund.

The carried interest documentation is usually drafted to include good/bad leaver clauses, vesting conditions and restrictions on the transferability of the carried interest.

From a tax standpoint, the advantage of carried interest is that it may in certain circumstances be taxed as capital gains rather than employment income, often with the result that, compared to a bonus which would be taxed as employment income, carried interest attracts a lower tax rate and

lower/no social security charges. It should be noted however that in many jurisdictions the existence of the good/bad leaver clauses, vesting conditions and transfer restrictions clauses can give carried interest the hallmark of employment income, which needs to be managed in order to achieve capital gains treatment.

The ability to have carried interest classified as capital gains, and furthermore, in certain jurisdictions, to access preferential tax rates which apply to particular types of capital gains, will depend on the location of the fund, how precisely it is structured, and whether the holding of the carried interest is via a special purpose vehicle. The legal documentation and structure of the fund itself are crucial and proper advice should be sought.

General approach by Asian tax authorities

Generally the tax authorities of Asian countries have yet to formally announce their stance on the treatment of carried interest. Whilst limited guidance exists on share based benefits paid to employees there is generally no mention of carried interest plans.

Therefore it is generally unclear whether carried interest should be taxed as compensation for services rendered, or as an investment generating an investment-like (and hence, in some jurisdictions, tax free) return.

In some jurisdictions, if structured properly, there is a strong argument that a carried interest plan should be treated as the latter, particularly where the participants paid fair market value for their interest upon acquisition.

In other jurisdictions, the receipt of an acquisition of carried interest may be subject to income tax and social security where the consideration given was below fair market value (**FMV**), and a benefit in kind received. There is generally no formal methodology agreed to determine the FMV of the carry right and, where the general partner holds a large amount of discretion over the amount of carried interest that could be paid out in future, or the likelihood of carry being received is very uncertain, it may be possible to argue that the FMV at acquisition is quite low, reducing any benefit in kind recognised at acquisition. Further the receipt of carry may be subject to income tax at usual rates.

In many jurisdictions there may be planning opportunities to mitigate the taxation on grant of carried interest and receipt of carry by executives, although the complexities of implementation may be a deterrent.

Funds considering the implementation of a carry plan should seek specific advice on the potential treatment of the interest in the relevant jurisdiction.

Conclusion

Carried interest plans, where properly implemented, can provide both economic and commercial benefits to fund investors and executives.

However, whilst possibly providing significant rewards, carried interest plans do not come without their pitfalls. The executives are not guaranteed a payout and, even where a fund performs well, it may take time to reach the hurdle level of return before which the carried interest holders are not rewarded. Co-investment usually required by carry holders, from their own pockets, could also be lost.

Any executives entering such a plan should be made fully aware of the potential risks and rewards, allowing them to weight up the costs and benefits for their personal situation. It seems that tax authorities in the Asia Pacific region have not yet developed firm or consistent views on the tax treatment of such plans, and there may be opportunities to structure the plan to optimise after tax returns for executives.



Darren Docker
Director

M&A Tax

PricewaterhouseCoopers
United Kingdom

+44 20 7804 6697
darren.m.docker@uk.pwc.com



Marianne Edwards
Manager

M&A Tax

PricewaterhouseCoopers
United Kingdom

+44 20 7213 3210
marianne.l.edwards@uk.pwc.com

Darren is currently a director in the UK M&A team and is a qualified Chartered Accountant and Chartered Tax Adviser. He has specialised in private equity for the past 8 years, initially on tax aspects of deal structures, but latterly focusing predominantly on fund structuring. He has advised on numerous private equity fund structures; and other alternative asset managers for example, European infrastructure funds, mezzanine funds and property funds. This work includes extensive advice on carried interest and co-investment tax issues, and also portfolio company holding structures.

Marianne is a manager in the UK M&A team and is a qualified Chartered Accountant and Chartered Tax Adviser. She has recently specialised in private equity, working closely with Darren on fund structuring. To date, she has advised on several European infrastructure funds and distressed debt funds. This work has included advice on carried interest and co-investment tax issues, as well as portfolio company holding structures.

Islamic and Shariah compliant private equity funds

Islamic private equity (PE) funds are finally presented with the opportunity to take the lead and drive the Islamic finance sector to the next level of growth. Given the current economic backdrop, Islamic PE funds are finding themselves in a position of having increased access to quality stocks and properties at lower prices. With stock valuations decreasing and expected to continue decreasing globally, it is indeed an attractive time for Islamic PE funds to invest.

Some will say that Islamic PE within a properly constructed partnership or joint venture arrangement is a true manifestation of Shariah business principles.

Key Islamic principles

Broadly speaking, there is fundamentally not very much difference between the structure of a conventional PE fund and its Islamic counterpart. The main difference is that the Islamic PE fund is a fund managed in a Shariah-compliant manner and used principally for acquiring stakes in privately-held Shariah-compliant companies. Investments that are Shariah-compliant generally relate to investments that stay clear of the following:

- Taking and paying of interest (*riba*);
- Speculative investments (*gharar*);
- Impure assets (*haram*), i.e., assets related to pork, alcohol,

pornography, gambling or even the defence industry.

Investments made based on Shariah principles can be seen to be a form of ethical investing. Hence, Shariah compliant PE funds would not invest in a company involved in assets which are haram such as a company selling alcohol or involved in gaming (e.g., casinos) and the funding obtained has to be Shariah based financing.

Shariah-compliance

Islamic PE funds are typically based on Musharakah (joint-venture where both partners may contribute capital and or know-how) or Murabahah (profit-sharing agreement between financier and entrepreneur).

Given that a large number of conventional asset-based PE partnerships are also Shariah-compatible, the distinguishing factor of Islamic finance is the type of underlying asset used and the investment structure (i.e., the proposed contract, financing and instrument structure) adopted.

Islamic fund managers are generally tasked with ensuring that the asset or business activity in question does not contain any haram elements, and that the investments considered are not speculative in nature. Other considerations to be taken into account relate to the amount of leverage in a company, the use of debt instruments and the extent to which the business activities are based on tangible assets.

In acknowledging the complexities involved in determining the appropriateness of investments, Shariah fund managers usually seek the guidance of boards of Shariah advisers. For example, in some instances, certain marginally low thresholds of "impure" assets may be accepted by the Shariah Board where there is a need to "purify" the relevant income through donation to approved charities. More often than not however, most obstacles faced by Islamic fund managers can be overcome by innovative structuring.

Outlook and challenges

One of the major challenges faced in the past by Islamic PE funds was their difficulty in competing with the returns offered by conventional funds. This is because Islamic funds in countries without Islamic banking system were unable to leverage their investments to the same degree as compared to conventional funds which tended to use substantial amounts of leverage from third party banks. However given the current financial crisis and shrinking yield expectations, pure equity investments may increase in popularity, and Islamic PE funds in non-Islamic finance jurisdictions may finally be able to provide equally competitive returns to those provided by conventional funds.

This could potentially give an edge to both the muslim investors and consequently to Islamic PE funds within the Islamic PE space.

Another obstacle generally faced by Islamic PE funds is the tax burdens in most jurisdictions where there is no specific tax legislation on Shariah transactions. Where conventional PE funds have established investment strategies to minimise their tax burdens, Islamic funds often find it difficult to mitigate taxes or are sometimes even faced with additional layers of tax due to the circuitous structures sometimes needed in Shariah-compliant financing structures.

More and more jurisdictions such as Malaysia, Singapore and United Kingdom have provided tax neutrality rules to ensure that additional taxes would not be applicable to Shariah funding. Jurisdictions such as Malaysia also provided added exemptions and incentives so that Islamic PE funds are provided with tax exemptions or tax incentives to operate from.

The silver lining to the current gloomy financial outlook is the potential opportunities that it presents to Islamic PE sector. Not only are more investors looking towards Shariah funds, which appear to be less affected by the global financial crises, but existing Islamic PE funds are looking for assets which they can acquire at more competitive prices. Islamic PE is poised for growth and it is indeed timely that an alternative form of investing is starting to be noticed by investors globally.



Jennifer Chang
Partner

Financial Services
PricewaterhouseCoopers
Malaysia

+60 3 2173 1828
jennifer.chang@my.pwc.com



Charlini Yogeswaran
Senior Tax Associate

Financial Services
PricewaterhouseCoopers
Malaysia

+60 3 2173 1430
charlini.yogeswaran.thambaiya@my.pwc.com

Jennifer specialises in tax for the financial services sector in Malaysia. She has extensive experience in Islamic financing transactions advising international financial institutions, including PE funds in Malaysia on matters relating to tax, structuring and regulatory matters relating to Islamic financing. Jennifer has played a significant role in the changes to the Islamic financing tax regulations in Malaysia including formulating tax incentives to promote Malaysia as an Islamic finance centre and regularly liaises with the relevant authorities on Islamic financing tax issues.

Charlini specialises in tax for the financial services sector in Malaysia. She has significant experience in Islamic financing transactions in Malaysia including advising international financial institutions in areas of tax, structuring and regulatory matters. Charlini also frequently liaises with the relevant authorities on Islamic financing tax issues.

Challenges for Asia Pacific regional based fund managers: lessons from China

Private equity (PE) investments in China continue to attract significant attention across the PE spectrum. However, the current international situation has created a new set of challenges for PE fund managers. Although the attention remains focused on financial performance, key points to be considered nowadays also include risk management and value creation. From a tax perspective, these current challenges include managing tax risks related to the fund and its investors, as well as managing the tax treatment of the carried interest plan for the managers in order to attract and retain management talent.

In this article, we will focus on managing the risks related to the fund, its investors, and the aspects related to carried interest plans for the fund managers from a Chinese, Hong Kong and U.S. tax perspective.

Structure of a PE fund

A common structure for PE funds investing in China is a Cayman Islands Exempt Limited Partnership (Cayman LP), with a Cayman fund manager that employs the services of a Hong Kong advisory company.

This typical fund structure is depicted in Figure 1.

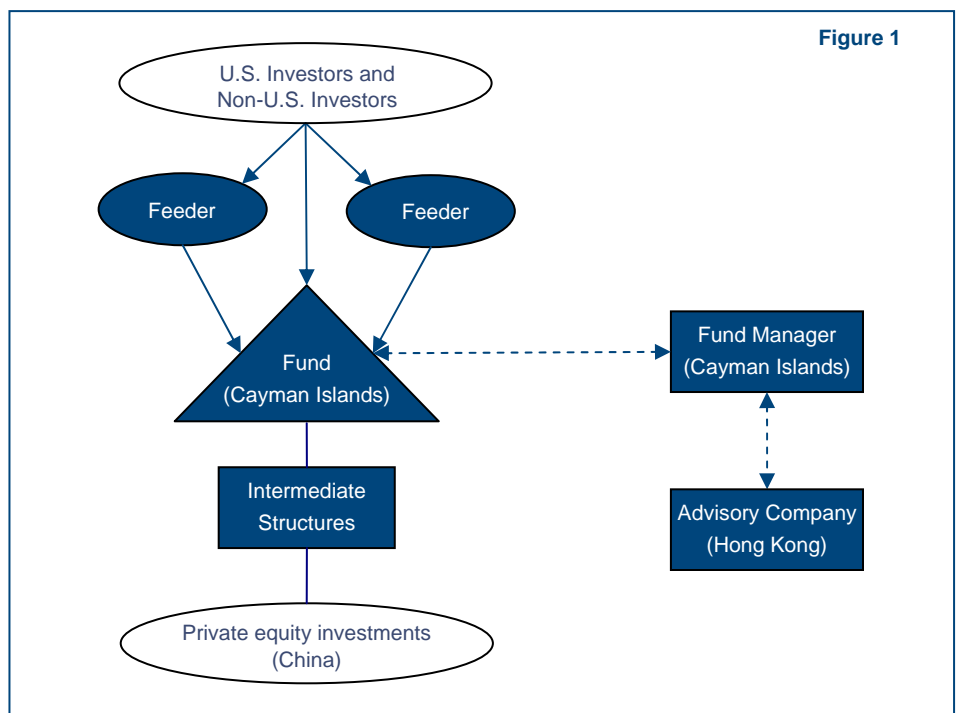
Managing tax risks

TRE/PE risks in China and Hong Kong

In managing the tax risks related to the fund, from a Chinese tax perspective the Cayman LP should avoid being viewed as a tax resident enterprise (TRE) in China or having an establishment in China. This is to avoid the Cayman LP being subject to Chinese corporate income tax. Likewise, the fund manager and the advisory company should avoid being viewed as a TRE in China or having an establishment or permanent establishment under a tax treaty (collectively referred as permanent establishment for simplicity). In case of

a permanent establishment, the management fee and/or the advisory fee would be exposed to Chinese tax. Furthermore, the investment team members who are Chinese nationals or foreigners who travel into China may be subject to Chinese Individual Income Tax (IIT).

To mitigate the TRE risk, an offshore fund or fund manager should make sure that none of the offshore entities are managed from China. Based on our experience the offshore entities of the fund should have foreign directors, board meetings and accounting records should be maintained outside of China, and major senior management should be based outside of China.



To manage the permanent establishment risk, all of the offshore entities should avoid having a fixed place of business in China. A Chinese entity should not make its office premises available to those offshore entities on a long term basis. Further, travel into China should be carefully monitored to ensure that the necessary trips do not trigger a so-called service permanent establishment, and onshore entities/persons should not have the general authority to conclude any contract on behalf of the offshore entities in order to avoid being regarded as a business agent of any offshore entities of the fund.

Similar to the potential Chinese corporate income tax exposure, the Cayman LP and the fund manager need to be safeguarded from any Hong Kong profits tax exposure which may be created due to the activities of the advisory company. Ongoing monitoring of the activities of the advisory company and the implementation of a transfer pricing policy is of the utmost importance in this respect. Moreover, the Hong Kong offshore funds exemption regime may provide an extra level of assurance that the Cayman LP will not be subject to Hong Kong profits tax.

The above are general principles only. In practice, what is more important is to establish effective internal control procedures and to maintain sufficient documentary evidence to defend the “no permanent establishment” assertion. For example, the fund's investment committee should not hold

meetings in China in order to mitigate the TRE/permanent establishment risk. However, if the majority of the members of the investment committee are based in China, it would be challenging to establish sufficient documentary evidence that the China-based members are not involved in the investment decision while they are physically based in China.

For the fund manager and the advisory company, their investment management team's presence in China may trigger service permanent establishments. As an industry practice, if the investment management team has to travel into China frequently, a Chinese entity should be set up to house the frequent travellers. Such onshore entity would be compensated by the advisory company or fund manager under an inter-company service agreement. Since all of the onshore entity's revenue would be derived from related parties, this related party transaction would be exposed to the Chinese tax authorities (disclosure is required in the onshore entity's audited financials as well as the entity's annual filing corporate income tax return package). Therefore, transfer pricing could become another challenge.

Holding structure risks

It is common practice for offshore funds investing into China to set up intermediate holding companies, which are incorporated or resident in a treaty friendly jurisdiction, in order to reduce

the Chinese withholding tax on gains/dividends derived from their Chinese portfolio companies. However, this may become more difficult in view of the Chinese general anti-avoidance rules (**GAAR**) contained in the recently published Special Tax Adjustments Implementation Measures. The GAAR place a special focus on the principle of substance over form. The consequence could be that the Chinese tax authorities may disregard the “tax benefits” solicited from the tax avoidance arrangements. Where an enterprise that is lacking adequate business substance, especially where incorporated in a tax haven jurisdiction, the Chinese tax authorities may disregard the existence of the enterprise.

Recently, a case in Chongqing, published on the local tax authority's website, held that a Singapore entity had to pay Chinese withholding tax on gains from the disposal of shares in another Singapore entity based on the “substance over form” principle. However, at the time of the case such principle was not explicitly written in the Chinese tax law. An outline of this case is provided at the end of this article.

In another case in Xinjiang, published via a tax circular, the Xinjiang tax authority denied a Barbados company tax treaty benefits provided under the China-Barbados tax treaty. In the Xinjiang case the treaty benefit was denied because the taxpayer failed to prove its tax residency status through an information exchange process

between the two competent tax authorities.

In addition, the circular compliments the Xinjiang tax authority's systematic approach employed in the investigation of the commercial substance of the Barbados company.

In addition to the abovementioned cases, developments regarding the double tax treaties (re)negotiated by China suggest that the Chinese tax authorities are focused on changing the taxing right of capital gains in favour of China and including anti-avoidance provisions. One of the latest developments in this respect is the renegotiation of the China-Barbados double tax treaty. The current China-Barbados treaty gives the taxing rights on capital gains derived from the alienation of Chinese company's shares (regardless if it is property holding or not) by a Barbados holding company to Barbados. In other words, such capital gains are only taxable in Barbados and not in China. One of the purposes of the re-negotiation is to change this taxing right of capital gains in favour of China. China will also seek to include an anti-avoidance provision in the revised China-Barbados treaty.

Based on the above, it is obvious that the Chinese tax authorities are focusing on taxing capital gains and will scrutinise any offshore structures used and examine whether or not the PE fund is involved in any tax avoidance arrangements. In this regard, clients should revisit the current

investment structures for China to make sure that the holding structure will not be disregarded and that any treaty benefits will not be denied.

Appropriate holding structure should also be considered for the U.S. tax implications for U.S. investors in the fund. Typically, the objectives of U.S. investors are to achieve maximum deferral of income from the fund and obtain the preferential tax rate for long-term capital gains when the income is recognised. Therefore, the holding structure of the fund should consider the U.S. anti-deferral rules of controlled foreign corporation (**CFC**) and passive foreign investment company (**PFIC**). Appropriate planning could minimise the impact of the U.S. anti-deferral regimes for U.S. investors. For example, a PE fund generally holds its PE investments through a special purpose vehicle (**SPV**). An appropriate selection of the type of entity for the SPV, or an election to choose an entity classification of the SPV for U.S. tax purposes, would have significant impact on achieving the objectives of the U.S. investors.

A holding structure that would allow U.S. investors to claim foreign tax credit against their U.S. income tax liabilities for the income taxes paid by the SPV or investee company should also be considered.

Tax treatment of carried interest plans

In order to attract and retain management talent it is common for PE firms to provide the management team with attractive carried interest plans. The tax treatment of the individuals entitled to such carried interest plans has a significant impact on the overall return that these individuals may receive.

Chinese carried interest tax aspects

For Chinese nationals domiciled in China, their worldwide income should be subject to Chinese IIT. If they are shareholders of a foreign entity (like the fund manager), any dividends received from the foreign entity would be subject to Chinese IIT at 20%. Unlike the dividend income, employment income would be taxed at progressive rates up to 45%.

For foreigners who do not have their domicile in China, they are generally only subject to Chinese IIT on Chinese sourced income if they stay in China for less than 5 years. Dividends from a foreign entity (like the GP) would be foreign sourced income. However, employment income would be deemed as Chinese sourced if the employment duty is performed within China. If a foreigner travels into China, or works for a Chinese entity, his or her employment income may be subject to Chinese IIT depending on the period of time he/she spends in China and

whether the remuneration cost is borne by a Chinese entity.

Therefore, the nature of income (e.g., investment income vs. employment) is very important in the determination of the Chinese IIT liability.

Hong Kong tax treatment of carried interest

Regarding any Hong Kong based fund managers there are no specific provisions in the Hong Kong Inland Revenue Ordinance (i.e., law) and there is no specific guidance dealing with the taxation of a carried interest plan. For the carried interest distributions to be chargeable to Hong Kong salaries tax, they would need to be regarded as “income arising in or derived from Hong Kong from any office or employment of profit”. It is necessary to consider whether or not the distributions are received by virtue of their employment or by virtue of their investment in the fund. If the distributions are received by virtue of employment, then the distributions would be chargeable to Hong Kong salaries tax at the rate of 15%. If they are received by virtue of their investment in the fund, then the distributions should be regarded as investment income which is capital in nature and not taxable in Hong Kong.

U.S. tax treatment of carried interest

Currently, carried interest received by a U.S. fund manager is treated as

capital gains if the carried interest considered as a fund manager’s incentive compensation is properly structured. Therefore, it is critical that the fund structure allow the character of capital gain to flow to the U.S. manager.

However, on February 26, 2009, President Barack Obama released an overview of his fiscal year 2010 budget. The overview includes significant tax increase proposals on business, one of which is to tax carried interest as ordinary income. It is thus likely that the carried interest would soon be taxed as ordinary income.

Chongqing case

The Chongqing tax authority sought to levy Chinese withholding income tax on gains derived by an overseas company from the transfer of another overseas company's shares to a Chinese buyer. We set out below a summary of the case.

Facts

This case is about the collection of withholding income tax on transfer gains derived by an overseas holding company which was transferring another overseas company's shares to a Chinese buyer.

In this case, the Transferor (Company B) originally held 100% shares of the Target (Company C). The Transferor and Target were Singapore registered companies. The Target held 31.6%

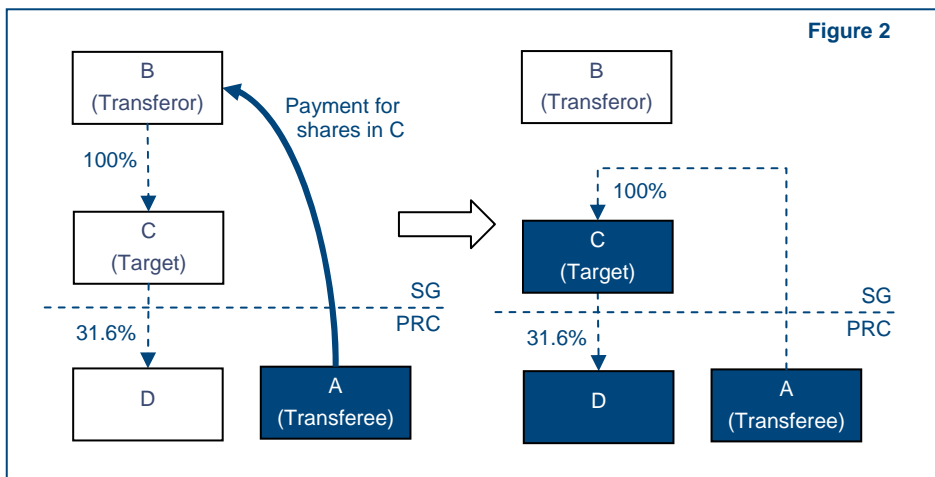
equity interest of a Chinese company (Company D). Except for holding the interest in the Chinese company, the Target did not carry out other businesses.

The Transferor transferred 100% shares in the Target to the Transferee (Company A), which was another Chinese company, and derived gains of around RMB 9 million.

The transaction is depicted in **Figure 2**.

Despite the fact that the Transferor and the Target are outside China, the Chongqing tax authority determined that since the Target did not carry out other businesses except for holding of the interest in Company D, the transfer of the Target by the Transferor was, in substance, the transfer of the 31.6% interest in the Chinese Company D by the Transferor.

Pursuant to Article 3.3 of the Corporate Income Tax Law and Article 13.5 of the Singapore-China tax treaty, the gains derived by the Transferor were essentially derived from China and thus should be subject to China withholding income tax. This case was opened in May 2008 and closed in October 2008. The Chongqing tax authority ultimately collected 10% withholding income tax on the entire amount of the gains derived by the Transferor.



Rex Chan
Partner
China Tax Services
PricewaterhouseCoopers
China
+86 10 6533 2022
rex.c.chan@cn.pwc.com



David Kan
Director
Financial Services
PricewaterhouseCoopers
Hong Kong
+85 2 2289 3502
david.kh.kan@hk.pwc.com



Terry Tam
Partner
China Tax Services
PricewaterhouseCoopers
China
+86 21 2323 1555
terry.sy.tam@cn.pwc.com

Rex has extensive knowledge and experience in structuring cross-border transactions and providing pre-investment/pre-acquisition tax analysis for clients investing in the PRC. He has assisted many private equities in structuring their China investments, including holding structure and operations related tax advice.

David specialises in tax for the financial services sector. He has extensive experience in advising on the structuring of funds, investments and the management group.

Terry specialises in providing U.S. tax consulting and compliance services including cross-border investment and structuring for multinational companies and private equity funds.

Tax examiners at the gate: the rise of transfer pricing for private equity firms

For many multinational financial services clients, other than banks and the largest investment managers, transfer pricing has historically been considered a less urgent priority than many other tax risks. Unfortunately, this is no longer the case. In fact, the position now is quite the opposite – transfer pricing has become a key tax risk management issue for all taxpayers, regardless of the industry in which they operate. Unsurprisingly, this change has engulfed the private equity (PE) industry as well, particularly given the expansion of both foreign and local PE firms throughout Asia (particularly India and China) in order to take advantage of the increase in investment opportunities, and the “sensational” media coverage many PE deals in Asia have received.

Given this new environment, what are the key issues that PE groups should be cognisant of when implementing or updating a transfer pricing policy? This article is designed as a transfer pricing “primer” for the PE industry, and outlines some of the key considerations and most commonly identified issues that arise in developing transfer pricing policies for PE groups. This is by no means an exhaustive summary: in the current environment transfer pricing legislation and documentary requirements are expanding to new countries almost daily; moreover, the level and area of transfer pricing risk will differ from firm to firm depending on business structure and scope of activity (both geographic and functional). However, this article should provide a useful

starting point for tax professionals in the PE industry about to step into the transfer pricing world.

Overview of transfer pricing for PE groups

A typical structure for PE groups involves the payment of fees for investment advice by the fund (**Fund**) or its general partner (**General Partner**) to an adviser (**Fund Adviser**). In such structures, the key transfer pricing issues are typically focused on the allocation of those fees between the Fund Adviser and any of its subsidiaries or related parties (**Local Affiliates**), where those Local Affiliates are located in overseas jurisdictions^{1, 2}.

The first step in any transfer pricing analysis is to obtain a thorough understanding of the functions performed by the parties to the transaction under consideration. Therefore, for the purposes of this article, a summary of the usual division of functions in a PE transaction is shown in **Figure 1**.

As can be seen, the activities performed by Local Affiliates typically cover deal origination and ongoing monitoring of any company in which the group has invested (**Portfolio Company**) in Local Affiliates’ jurisdictions. Capital raising and portfolio management are typically performed centrally by the General Partner or Fund Adviser.

For the purposes of this article, references to “fees” paid to the Fund Adviser are intended to include all fees paid by the Fund, such as advisory fees (typically 1%-2% of committed capital during the investment period; thereafter typically invested equity), transaction fees, abort fees or monitoring fees; and potentially carried interest (typically 20% of gains above a hurdle rate of return). However, it should be clearly understood that there are special issues relating to carried interest that do not typically apply to other categories of fee. For example:

- Is the carried interest a payment that should form part of the revenues to be allocated among the entities of the PE group? The treatment of carried interest will differ from one group to another depending on both the corporate and carried interest structures adopted, as well as on the position taken by the tax authorities of the jurisdictions in which the group operates.
- If the decision is made to classify carried interest as “corporate revenue”, the following additional points should be considered:
 - Which functions should share in the carried interest? Although calculation of the performance fee suggests a close relationship to portfolio management and possibly deal origination, it may be that the performance of the Fund has also been improved by

the capital raising function, i.e., to a certain degree, the more capital raised the more flexibility there is when making investment decisions.

- The timing (at closure of the fund) and manner of payment (internal hurdle) of the carried interest may not be consistent with the arrangements in a third party transaction, e.g., in the timing (at closure of a deal) and manner of payment (fixed fee or percentage of capital raised) of a performance fee paid to a third party placement agent

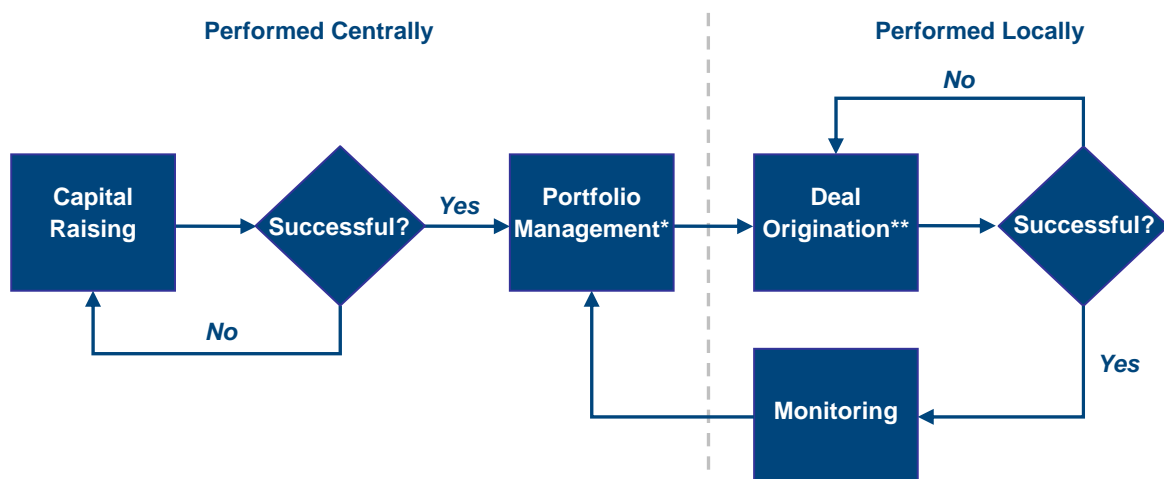
(for the capital raising function). This could create cash flow issues if third party fees are used to determine the price for certain intercompany transactions.

- Where employees receive a portion of the carried interest as a discretionary incentive payment, how should this be reflected in the transfer pricing methodology used to compensate the legal entity that employs them? In addition, there may be differences in the timing of bonus payments to

employees (usually annually) and the timing of payment of carried interest (at closure of a deal or the fund). Thus, there may be costs incurred by Local Affiliates for which no revenue has yet been recognised.

- How should clawback³ provisions for the current fiscal year be exercised if the carried interest to which those provisions relate has been paid out to the Local Affiliates through the transfer pricing in a prior fiscal year?

Figure 1: Private Equity Transaction Flow Chart



* Includes functions such as setting investment strategy; portfolio monitoring; determining exit strategy; etc.

** Includes functions such as investment research; due diligence; language support; sourcing; structure financing; etc.

- The carried interest may not be paid to the Fund Adviser. Accordingly, there may be difficulties in identifying a legal form under which the carried interest can be paid to either the Fund Adviser or Local Affiliates, if the transfer pricing policy so requires.

Deconstruction of a PE business

One of the mistakes often made when addressing transfer pricing risks and implementing new transfer pricing policies is to assume that there is a “one size fits all” answer for an entire industry, such as the PE industry, or a whole country, e.g., Japan. In fact, while there are characteristics of and trends within industries, and while there are well-established transfer pricing guidelines (such as those laid out by the Organisation for Economic Cooperation and Development (OECD)) that are in principle followed by many tax authorities, there are also innumerable differences in individual corporate structures and in the specific functions performed by each entity within an enterprise, which make it impossible to develop a standard approach. This is particularly so in the PE industry, which is younger and less regulated than other financial services industries.

Therefore, as noted earlier, the first step in developing a comprehensive transfer pricing policy is a thorough and detailed analysis of the functions performed and risks assumed by each group entity. Based on that analysis, a

decision can be made about the level at which the policy should be implemented. That is, is it appropriate to treat each function separately with a stand alone fee arrangement? Or is it better to consider the Fund Adviser and Local Affiliates a single integrated business, with a single transfer pricing methodology? These considerations, and others, are discussed in more detail below in respect of each of the functions shown in Figure 1. Moreover, in order to highlight the areas where PE groups are most likely to encounter difficulties, the functions have been listed in order of probability that a transfer pricing issue will arise rather than in the order they are shown on Figure 1.

Deal origination

- The extent of the functions performed for deal origination varies within PE firms, depending on the level of expertise and experience of the professional staff. It is not uncommon for Local Affiliates in emerging markets to initially take on a supporting role with respect to sourcing of potential deals. However, as the local operations develop, the Local Affiliates will generally take on more responsibilities and make greater contributions to deal origination.
- If “deal origination” activities (see Figure 1) are considered key functions (typically with those functions incorporated in “portfolio management”), a sharing of total

corporate revenues received from the Fund (or total profits earned from the business) will need to be determined. In such cases, the mechanism to determine the appropriate sharing between the Fund Adviser and the relevant Local Affiliates may be derived in a number of ways, either from third party data or through an allocation based on some internal measure, such as headcount or staff compensation payments by each entity.

- Where the group pays fees to third party deal originators or advisers, these payments could be used as some form of proxy for the fees to be paid to the captive deal originators, the Local Affiliates. Alternatively, publicly available data about fees paid to such third party advisers in the PE industry could also be used for this purpose.
- If there is a specific transaction fee (or abort fee) paid by the Fund or General Partner, consideration should be given to whether 100% of that payment is due to the Local Affiliates, or whether other entities – in particular the Fund Adviser – also contributed to the specific deal originated. In the latter case, the fees received will need to be allocated between the relevant entities in a similar manner to that described above for total revenues or profits.
- If specific fee data is not available (either internally or externally), and

a sharing of total revenues or profits is not appropriate, a target level of profit for the Local Affiliates may be determined based on the profit margins of third party companies engaged in similar deal origination activities. Ideally these would be third parties in the PE industry; however, if such specific data is not available a broader industry or functional search may be required.

- When using the profit results of the third party companies to determine an appropriate target profit level for the Local Affiliates, it has frequently been the case that PE groups have relied on the cost plus mark up methodology. It is important to understand the details of the functions performed and relative contribution made by the Local Affiliates to determine whether this method can be reasonably applied. In addition, when determining whether a cost plus method is appropriate for specific Local Affiliates, care should be taken to understand the practice of the tax authorities in that jurisdiction. For example, there are now a number of jurisdictions where remuneration by way of a cost plus mark up methodology is likely to be challenged when applied to deal origination activities. In addition, even where a jurisdiction accepts the cost plus mark up methodology in principle, such as India (where many PE firms have used this model for research

activities performed by their Local Affiliates), the tax authorities may still argue for a relatively high mark up. Alternatively, a similar level of profitability may be achieved, but through the use of other methods (such as a fee-based approach).

Capital raising

- As with deal origination above, there may well be internal data about actual fees paid to third party placement agents by the PE group itself, or there may be publicly available information about fees paid to placement agents in the PE industry generally. Either of these data sources could be used as a guide to the fees to be paid to the captive capital raiser(s).
- Is the value of the capital raising activity constant over time? For example, if Fund 1 is successful it may be much easier to raise capital for Funds 2, 3, etc., particularly if the existing Fund 1 investors are given priority to invest in future funds. In such cases, the capital raising activity may be facilitated by the reputation of the Fund Adviser.
- In contrast, the capital raising activity may become much more valuable to a PE group in difficult economic times, particularly when there is a liquidity shortage in global financial markets. In such cases it may be necessary to

consider the impact of the additional time and effort spent on capital raising as the investment period becomes longer and more complex, e.g., where there are multiple closes.

Portfolio management

- If portfolio management has been identified as the key function of the group, there may be no need to determine a fee paid specifically for this function. Instead, the remuneration for portfolio management is likely to be the residual of fees received from the Fund or General Partner after all other functions have been remunerated.
- If portfolio management is one or more of several key functions, a sharing of revenues received from the Fund (or profits earned from the business) will need to be determined. As noted above, the mechanism to determine the appropriate sharing between the Fund Adviser and the relevant Local Affiliates in such cases may be derived in a number of ways, either from third party data or through an allocation based on some internal measure.

Monitoring of portfolio companies

- Monitoring activities are less likely to form part of a PE group's global transfer pricing policy if they are paid by the Portfolio Company and thus not out of the fees paid to the Fund Adviser by the Fund or General Partner. In such cases, they are usually domestic transactions and thus may not be subject to transfer pricing rules in many jurisdictions⁴.
- As for deal origination, if there is a specific monitoring fee paid by the Fund or General Partner, this may require allocation with other entities rather than being paid solely to the Local Affiliates in the jurisdiction of the Portfolio Company.
- If there is not a specific monitoring fee, the payment to the Local Affiliates will typically be a payment for some form of management or consulting services rendered to the Portfolio Company. The usual considerations in relation to intercompany management fees will apply in such cases, in particular recognition that the terminology "monitoring" covers a wide range of potential services.

recently received in the media – particularly in Asia, has increased the likelihood that a PE group could be subject to tax audit scrutiny. Accordingly, this article introduces some key issues to consider when developing a transfer pricing policy in the PE sphere.

However, the purpose of this article is not to recommend a single approach to transfer pricing for the PE industry. Instead, this article aims to demonstrate that the approach selected will vary from group to group. Thus, the first step in developing a transfer pricing policy must be a clear understanding of the functions performed by each entity, and the importance of those functions to the group as a whole. In addition the impact of other tax risks (e.g., permanent establishment exposures for the Fund or the income tax characterisation of carried interest at the entity as well as employee level), should be considered. Only once the understanding of all these factors is complete can decisions be made about the most appropriate pricing methodologies for a PE group.

Conclusion

As discussed above, the stronger focus on transfer pricing by tax authorities generally, coupled with the attention that the PE industry has



Ryann Thomas
Managing Director

Transfer Pricing

PricewaterhouseCoopers
Japan

+81 3 5251 2356
ryann.thomas@jp.pwc.com

Ryann assists both inbound and outbound multinational corporations with transfer pricing audit defence, advance pricing agreements, documentation and economic analyses, and risk assessments. While her transfer pricing experience covers clients in almost all industries, Ryann specialises in transfer pricing issues relating to financial institutions.



Dhaivat Anjaria
Partner

Transfer Pricing

PricewaterhouseCoopers
India

+91 22 6689 1333
dhaivat.anjaria@in.pwc.com

Dhaivat, a Chartered Accountant and MBA, has over 14 years of professional experience, with his transfer pricing clientele being concentrated in the area of financial services. Dhaivat's transfer pricing experience includes planning, documentation and developing defence strategies on transfer pricing audits.



Shyamala Vyrapillai
Senior Manager

Transfer Pricing

PricewaterhouseCoopers
Hong Kong

+85 2 2289 5606
shyamala.vyrapillai@hk.pwc.com

Shyamala has more than six years experience in transfer pricing, specialising in the banking, funds and insurance sectors. Shyamala has advised major global banking, insurance and fund management clients on a diverse range of issues, including development of transfer pricing policy for integrated global trading books, assessment of high-value fee based businesses, loan pricing, head office service arrangements, pricing strategy for the provision of intellectual property, risk management and tax audit defence.



Mac Calva
Director

Transfer Pricing

PricewaterhouseCoopers
U.S.

+1 646 471 2368
mac.calva@us.pwc.com

Mac has over 13 years of experience assisting clients modelling transfer pricing policies, developing contemporaneous documentation, and analysing tax optimisation strategies. Mac has worked closely with major banks, hedge funds, fund of funds, PE firms, brokerage firms, and reinsurance companies on a wide range of projects, including evaluating transfer pricing policies for global trading, portfolio management, financial research services, reinsurance agreements, investment advisory and sub-advisory services, implementing profit split models, as well as developing supporting documentation for tax purposes.

-
- ¹ Note however, that fees paid to Local Affiliates in the same jurisdiction as the Fund Adviser should also be covered by a global transfer pricing policy. First, in the event of an audit, support for a transfer pricing policy is strengthened by being able to demonstrate that it is applied consistently to all Local Affiliates, wherever they may be located. Second, many tax authorities will also challenge transactions between domestic parties that are conducted in a manner so as to reduce the overall taxable income of the relevant jurisdiction.
 - ² Loans or guarantees provided from one entity of a private equity group to another entity of the same group are also intercompany transactions, and thus subject to transfer pricing rules and legislation. However, as the pricing in financial transactions is less influenced by specific characteristics of the private equity industry, we have treated these transactions as a separate topic and excluded them from this article.
 - ³ A clawback provision ensures that the total carried interest paid, often on a periodic basis, is not greater than the agreed percentage for carried interest over the life of the Fund.
 - ⁴ As described in footnote 1 above, there may be good reasons to justify including domestic transactions within the scope of a transfer pricing policy.

Effective tax planning to enhance cash flows for portfolio companies

The economic crisis has not only reduced access to funding, but raised the cost of existing debt, and with declining growth and lower profitability portfolio companies are experiencing increasing pressure to balance cash needs for operations with requirements from stakeholders. Further in these times debt holders are seeking greater assurance, and plans, that the companies can generate sufficient cash to meet their covenant obligations.

These challenges offer private equity (PE) firms the opportunity to review existing portfolio companies, to not only improve operations where possible, but to ensure that tax leakage from any inherited risks is minimised and operations are structured in the most tax efficient manner.

This article discusses typical risks inherited with portfolio companies, funding structures and cash repatriation methods, and opportunities to optimise cash flow through strategic and tax efficient planning.

Inherited tax risks

Common areas of tax risks for portfolio companies include transfer pricing, holding company structures and permanent establishment issues. Each of these issues is unique, and the level of risk varies according to tax jurisdiction and industry.

An oversight would be to ignore tax compliance and housekeeping during a crisis period. When profits are lower

and tax collections become thin, tax authorities generally focus on such areas and this can result in additional tax assessments. Even where indemnities and warranties exist, it is important to consider their value, especially in distressed merger and acquisition (M&A) transactions.

Revisiting or updating the due diligence report with better access to information, can usually address these areas of exposure without significant effort or costs.

Transfer pricing

Often significant inter-company transactions identified during a high-level due diligence phase would likely have been unsubstantiated by relevant documents, or access to such details may have been limited.

Accordingly, these should be screened for red flags that could attract potential tax liability. Examples include persistent losses or low operating profits, different prices or mark-ups charged for similar inter-company transactions, significant inter-company management fees and significant year-end adjustment to inter-company prices.

In this respect, transfer pricing analyses and documentation are critical. For multinational companies with affiliates in various countries, a global transfer pricing policy is essential. Local documentation in compliance with a country's transfer

pricing rules should be prepared to minimise potential exposure and future costs. The absence of inter-company agreements can usually be easily addressed. While it may take more effort to produce a full transfer pricing report, it may be possible to undertake a high level analysis as a protective measure.

Holding company structures

The location of a holding company structure is important from a tax perspective as it may have implications for repatriation costs.

Substance at the holding company level is also important as different jurisdictions impose varying substance requirements for companies claiming benefits under double tax treaties. These requirements may be enforced by the tax authorities in either the jurisdiction where the holding company is incorporated or where the relevant investment subsidiary is located.

Additional due diligence after the completion of an acquisition should be undertaken to ensure that the necessary substance requirements are met and maintained (especially where pressure on costs arise).

Permanent establishment

In some cases, companies overlook the risks of a permanent establishment outside their jurisdiction of incorporation, and as such do not keep documentation or separate records of

profits that might be attributable to a permanent establishment.

Often permanent establishment risks may arise from existing operational structures and approval processes (e.g., employees in a foreign jurisdiction with authority to negotiate and conclude contracts) and a high level review of the business structure may help to reduce this risk. It would usually be possible to undertake this review without major impact to operations and this could help mitigate a costly tax assessment.

Sale and purchase agreements

Tax warranties and indemnities in sale and purchase agreements are obviously to provide protection and recourse to the acquirer. These are generally provided with specific conditions on what the acquirer and target management can or cannot do after acquisition. There is therefore the risk for disputes when tax liabilities crystallise and recourse is sought.

In this regard, tax positions adopted post-acquisition can result in a tax authority raising additional taxes covering the pre-acquisition period. In these circumstances, a dispute may arise as to whether the additional tax liability was caused by an act of the acquirer or the target management.

As such, careful consideration should be given to historic tax risks, and the availability of recourse, before making

decisions with regard to changes in existing tax positions or planning.

Repatriation

Dividends

Dividend payments may be subject to withholding tax of up to 20% in some Asia Pacific jurisdictions, in addition to corporate tax paid. Further, certain laws and regulations may restrict the amount of dividends that can be paid; this includes the availability of profit reserves, franking credits and the need to obtain the approval from foreign exchange authorities.

Where a commercial purpose exists, operations should be examined to determine if a restructure can be undertaken to provide for easier dividend repatriation and whether that can be complemented with other fund flows.

Moreover, a change in law may permit a more tax efficient repatriation of dividends that was not considered in the acquisition model.

Inter-company loans

Extending an inter-company loan may facilitate cash repatriation between related companies to help meet liquidity needs. However, tax and other rules in both the lender and borrower jurisdictions (e.g., transfer pricing, withholding tax, deductibility of interest expense, thin capitalisation) may raise costs

For example, under transfer pricing rules a lender may be required to charge an arm's length interest rate on the loan, however due to the operation of thin capitalisation rules in the borrowers' jurisdiction, the interest may, in whole or in part, be non-deductible. Where the interest received by the lender is subject to tax, then to the extent that the interest is non-deductible in determining the taxable income of the borrower, the loan would result in an increase in the effective tax rate for the group. Further, the accounting profits and retained earnings of the borrower would be reduced, thus lowering the flow of dividends to shareholders.

As this example demonstrates, where inter-company loans are made, it is vital that they are structured appropriately to ensure that the borrower can claim interest deductions so as to minimise the group's overall tax costs (from a cash and accounting perspective).

Share redemption

The redemption of shares out of capital has the advantage over a dividend payment, in some jurisdictions, where the redemption should not be subject to tax for both the payer and recipient jurisdictions. However, it may be important that it can be demonstrated to the satisfaction of the tax authorities that such payments are not distributions of profits.

A commercial disadvantage of this method of cash repatriation is that generally they are far more regulated and can take significant time to implement as consideration must be given to protecting creditors' interests.

In some jurisdictions such as Singapore, a company may redeem its shares out of capital by a special resolution that may serve to reduce the time. However, this can place considerable onus on the directors under corporate law requirements.

Restructuring loans

As loan tenures come to an end, or where there is a possible withdrawal of existing facilities due to a potential breach of loan covenants, borrowers are likely to come under increasing pressure from banks to service their loans. In this regard, PE firms and their portfolio companies are being forced to quickly examine available options to find viable refinancing or even to inject new capital.

Case study

A holding company (**BidCo**) was incorporated in Singapore. BidCo obtained a loan, at high gearing levels, for the purpose of acquiring the shares in the holding company (**TargetCo**) of a group of manufacturing companies. Interest on the acquisition loan was not deductible and BidCo relied on the dividends received from TargetCo to service the loan and interest. Increased tax costs associated with the non-deductible interest incurred by BidCo were not considered material at the time of entering into the loan.

However, as economic conditions worsened and finance covenants were breached, their banks increased pressure on BidCo to have the loan directly secured by the assets of TargetCo rather than the shares in TargetCo, and to have the debt at the operating entity level.

As there was a commercial rationale for the consolidation of the separate business owned and operated by TargetCo and its subsidiaries, BidCo implemented a corporate restructure under which one of the subsidiaries (**OpCo**) borrowed funds from a bank to acquire the separate businesses of the remaining subsidiaries. Proceeds from the sale of the businesses were used by the subsidiaries to return funds to BidCo in a tax free manner and allowed BidCo to repay its loan.

As the interest costs incurred by OpCo were deductible in determining its

taxable income, then assuming an interest rate of 4% on a loan of approximately \$400 million, the restructure generated annual cash tax savings for the group of approximately \$2.7 million.

Law Changes

Recently, governments in various jurisdictions have announced economic stimulus packages, which include tax cuts and incentives to revive the economies. PE firms should review the group companies' operations and tax attributes to maximise cash flows arising from the tax savings following those announcements.

Case study

Target Co and SubCo1 are companies incorporated in Singapore. Singapore's tax rate is 17%. SubCo1 acts as distributor for the sale of widgets manufactured by SubCo2.

SubCo2 manufactures the widgets in Country A, 90% of which are exported from Country A to SubCo1 in Singapore. Country A is a higher tax jurisdiction with an effective tax rate of, say, 32.5%.

High capital costs of SubCo2's operations limit its ability to make dividend payments. However, technology used by SubCo2 in its manufacturing process is owned by SubCo1, and historically no payments were made in by SubCo2 for access to

the technology. Customer relationships were also owned by SubCo1.

In this case SubCo1 and SubCo2 entered into a contract manufacturing agreement post acquisition. Under the terms of the agreement SubCo2 was paid on a cost-plus basis. SubCo1 kept and maintained enterprise risks and rewards. Trapped cash in SubCo2 could be used to fund a retroactive payment for prior period use of technology.

In implementing a contract manufacturing arrangement and making retroactive payments for access to technology, a number of matters require consideration:

- There are risks that the tax authorities in Country A could question whether there was a transfer of business, or some other intangible to SubCo1 resulting, from a change in the terms;
- We were also able to document the facts that SubCo1 undertakes the marketing and has the relationships with customers.
- It was also important to identify a specific event or impetus to change the operations. In this regard, a change of ownership and a chance for integration provides an opportune time to justify the restructure.

Looking to streamline and preparing for potential exit

As values are depressed, PE firms are in the process of streamlining operations or using the opportunity to implement better operational cash flow, or even exit, plans. This is especially the case where an acquisition structure is not optimal in light of current development and revised forecasts and thus, a post-acquisition restructuring is desirable to minimise future tax costs and to allow for greater exit flexibility.

Conclusion

As financial conditions worsen, it is crucial for PE firms to review existing portfolio companies to not only improve operations where possible, but to seek opportunities to improve cash flow to service existing debt and continue equity distributions. This is especially the case where shareholders rely on such distribution to service acquisition gearing.

Depressed valuations may provide PE firms with an opportune time to implement these restructures in a tax efficient manner.



Chris Woo
Partner

M&A Tax

PwC Services LLP
Singapore

+65 6236 3688
chris.woo@sg.pwc.com



Sarah Wong
Manager

M&A Tax

PwC Services LLP
Singapore

+65 6236 7241
sarah.wc.wong@sg.pwc.com

Chris, leader of M&A Tax in Singapore, and Sarah both have broad experience in international tax planning and compliance, together with U.S. FAS109 and FIN48 matters. Chris and Sarah are serving PE, financial and strategic clients from the U.S., Europe, the Middle East and Asia, providing a wide range of tax structuring, planning and due diligence services.

China

Investing through RMB funds

Alternative RMB fund structures

In recent years, local Chinese currency (RMB) fund structures that have been set up by foreign private equity (PE) investors usually come in two different legal forms:

- Foreign-invested venture capital enterprise (**FIVCE**); and
- Domestic limited liability partnership (**Domestic LLP**).

FIVCE were first introduced in 2003 to allow venture capital investment by foreign investors. A FIVCE is established as a foreign investment enterprise (**FIE**) and can take the form of a non-legal person, i.e., an unincorporated co-operative joint venture (**CJV**), or a corporate legal person, i.e., CJV or equity joint venture (**EJV**). It is mainly designated for venture capital investment which refers specifically to equity investment in non-listed high-tech companies, though investment in other industries is also allowed as long as they are not prohibited projects in the *Foreign Investment Guidance Catalogue (FIGC)*.

Another emerging RMB fund structure takes the form of a domestic limited liability partnership (**Domestic LLP**). A Domestic LLP is organised under the amended PRC Partnership Law effective from June 1, 2007. The Domestic LLP structure allows pass-through taxation, provided for under Article 6 of the amended Partnership Law, whereby the partnership is

exempt from paying corporate income tax (**CIT**) by taxing the income to partners on a pass-through basis.

Currently, the Domestic LLP RMB fund structure is very much restricted to Chinese investors. However, there have been precedent cases where an FIE, e.g., a fund management and consulting wholly foreign owned enterprise (**WFOE**), is accepted as the general partner of a Domestic LLP RMB fund in Tianjin. Some of the local governments, including Tianjin and Shanghai governments, have made a high-profile statement by issuing local regulations to endorse the establishment of RMB fund structure in high hope to boost investment in the PE sector. In particular, the Tianjin government offers subsidies and incentives for RMB fund investment projects in Binhai District, a special region which is believed to have the blessing of the Central and local government to develop into a financial services centre of Northern China.

Tax considerations of the RMB fund structures

China has not issued comprehensive guidelines on the tax treatment of RMB funds, their partners and distributions. One of the important tax questions faced by the RMB funds is in relation to how many layers of taxes the RMB funds are subject to.

There is a general belief that the RMB fund structure, if structured properly, can achieve a tax pass-through status,

thus eliminating taxes at the fund level to avoid double taxation on the fund and its underlying investment. This statement is true for RMB funds organised in the form of a Domestic LLP.

For those foreign-invested RMB funds which take the form of FIVCE, they are exposed to significant uncertainty on how this tax pass-through treatment can be achieved. The reason is that the long-awaited Foreign-invested Partnership Regulations (**FIPR**) has yet to be introduced and in principle, foreign-invested LLP cannot be established until the formal issuance of the FIPR.

In order to address the tax pass-through treatment of FIVCE, the State Administration of Taxation (**SAT**) issued a tax circular, *Guoshuifa [2003] No.61 (Circular 61)*, which offers a window of opportunity to foreign-invested RMB funds taking the form of FIVCE. Under Circular 61, FIVCEs can apply to the local tax authorities and elect this tax pass-through treatment provided that they are organised as an unincorporated CJV, i.e., a non-legal person.

If this tax pass-through position is approved by the local tax authority, the RMB fund will be construed as transparent for tax purposes. That is, the fund itself will not be treated as a taxpayer and the partners of the fund will directly recognise their share of income generated by the fund for PRC income tax purposes.

However, the enactment of the new CIT Law, effective from January 1, 2008, has caused some local tax authorities to take the view that Circular 61 would no longer be valid pending new tax circulars on this subject. In the worst scenario, RMB funds would be subject to the following two layers of taxes:

- PRC CIT at the fund level on income derived from its underlying investment; and
- PRC withholding tax on distributions from the fund to the foreign partners.

Permanent establishment issue for the foreign partner

In the event that the RMB fund is able to secure the tax pass-through treatment from the local tax authorities, the next issue to consider is how the partners of the fund should be taxed with respect to their share of income generated by the fund.

Generally speaking, the foreign partners in the RMB fund, i.e., FIVCE, will have a much heavier tax burden on the distributions from the funds, i.e., 25% of CIT, if they are considered as having a permanent establishment in China. Therefore, it would be in the interest of the foreign partners of FIVCE to limit its presence in China to reduce their China tax exposure. However, Circular 61 has also imposed an unfavourable tax position on the foreign partners in cases where the FIVCE engages directly in the daily

management and operation of the fund instead of administering it through a separate Chinese fund manager. Accordingly, RMB funds which intend to minimise the PRC taxation of its foreign partners would have to carefully design its fund management structure by, say for example, appointing a separate PRC fund manager to handle the investment of the fund in China.

In contrast to the FIVCE, there appears to be more certainty in terms of the CIT treatment for a Domestic LLP. The tax pass-through status is generally applicable to a Domestic LLP as stipulated in the revised PRC Partnership Law. The investment income as derived from the RMB fund will be taxed at the partners' level, i.e., the FIE as the general partner and other limited partners, and the RMB fund will not be the taxing entity as an LLP. Under the PRC CIT regime, dividend income received by the partners from the underlying portfolio companies of the RMB fund will be exempt from CIT.

Treaty protection

In the event that the RMB fund is able to secure the tax pass-through treatment from the local tax authorities, the next issue to consider is how the partners of the fund should be taxed with respect to their share of income generated by the fund.

Generally speaking, distribution from the RMB fund to the foreign partners

without any taxable presence in China would only be subject to a 10% withholding tax (or lower effective tax rates as governed by the relevant tax treaties). Essentially, such distributions are dividend and capital gain generated from the underlying portfolio investments which flow through the fund to the partners.

The use of a suitable offshore intermediate holding vehicle to hold the foreign partner's interest in a RMB fund may not only increase the flexibility in the future exit options but also offer tax treaty protection to the foreign partners on future repatriation of dividend and capital gain generated by the fund. Various Sino-foreign tax treaties provide protection to foreign partners of the RMB fund by allowing them to enjoy a reduction of withholding tax on repatriation of fund distribution. However, it is important to note that matters like treaty shopping and anti-avoidance are now on the radar of the Chinese tax authorities. Therefore, the foreign partner would need to be prudent in selecting the right jurisdiction for setting up the holding structure for the fund.

Tax treaties commonly used for China investment

The table in **Figure 1** below summarises the withholding tax rates for dividend and capital gain received by investment holding vehicles in jurisdictions that are commonly used for PRC investment holding purposes.

Some future development

As the Chinese regulators continue to push for new laws and regulations to create a more regulated investment landscape for PE and venture capital sectors, the use of RMB fund structure will become an increasingly popular solution to the foreign industry players.

However, the uncertain tax rules in China for RMB funds may potentially create additional tax exposure for the foreign PE houses, thus reducing the after-tax return on the investment capital of the investors. The need to perform a tax reality check before closing the investment funds would be of paramount importance.



Danny Po
Partner

M&A Tax

PricewaterhouseCoopers
Hong Kong

+85 2 2289 3097
danny.po@hk.pwc.com



Jeremy Ngai
Partner

M&A Tax

PricewaterhouseCoopers
Hong Kong

+85 2 2289 5615
jeremy.cm.ngai@hk.pwc.com

Danny is the China National M&A Tax Leader of our China and Hong Kong firm. Danny has over 20 years of experience in the China tax and business advisory field. He works closely with his national team in other major China offices in M&A tax due diligence, deal negotiation support, tax restructuring and post-deal integration services for foreign investors in China.

Jeremy is a partner in the China Tax and Business Advisory division specialising in PRC M&A tax advisory. Jeremy has extensive experience in advising foreign investors in their inbound investment and M&A strategies into China, including consulting on entrance strategy, investment structure, financing structure, tax due diligence, repatriation of profits and tax ruling applications.

Figure 1

Treaties	Dividend tax	Equity capital gain tax
China – U.S.	10%	Exempt ² for less than 25% interest
China – Ireland	5% - 10% ¹	Exempt ²
China – Mauritius	5%	Exempt ² for less than 25% interest
China – Barbados	5%	Exempt
China – Singapore	5% - 10% ¹	Exempt ² for less than 25% interest
China – Hong Kong	5% - 10% ¹	Exempt ² for less than 25% interest

Note 1: The 5% withholding tax rate applies to dividends paid by a Chinese company to a resident of the other jurisdiction, provided that the recipient is a company that holds at least 25% of the capital of the Chinese company. 10% applies in all other cases.

Note 2: The exemption does not apply to sale of equity interest in 'property-rich' companies, whose value of immovable properties exceeds 50% of its total assets.

India

Key recent tax and regulatory developments concerning private equity investments

The last couple of years of the Indian economy have seen exponential growth, specifically for startups and growing businesses. India has a vibrant private equity (PE) and venture capital market, with foreign direct investment (FDI) of up to 100% permitted in most of the sectors under automatic route. Indian PE continues to grow and evolve, but the path hasn't always been upwards and to the right.

The ensuing paragraphs highlight certain noteworthy direct tax and regulatory developments that should be taken into consideration.

Tax developments

India's position on the recent update to the OECD commentary

The Organisation for Economic Co-operation and Development (OECD) has released "The 2008 Update to The OECD Model Convention". India is now granted an observer status and has for the first time given its comments/reservations on the OECD Model Commentary. Some of the key provisions on India's position are summarised below:

- **Residential status** – India is of the view that apart from the situs of commercial decisions and key management, the place where main and substantial activity is carried on should also be taken into account for determining the "place of effective management".

- **Treaty applicability to partnership firms** – India believes that the treaty benefits to partners would be possible only if specific clauses to that effect are included in the treaty.

- **Permanent Establishment**

Fixed Place permanent establishment

- India is of the view that a person working in different places on unrelated contracts for short duration may be held to have a permanent establishment if the overall stay in India is for a substantial period of time.
- India does not agree with the words "The 12 month test applies to each individual site or project". It considers that a series of consecutive short term sites or projects operated by a contractor would lead to existence of a permanent establishment in the country concerned.

Agency permanent establishment

- India is of the view that, in certain circumstances, mere participation in negotiations is sufficient to conclude that the person has exercised authority to conclude contracts.

Service permanent establishment

- India is of the view that for furnishing services in a country, physical presence is not essential.

Certain important judicial decisions

Vodafone International Holdings

In the instant case, Vodafone International Holdings, B.V. (VIH) acquired shares of offshore Hutchison Group Company which was, through a layer of downstream subsidiaries, holding a controlling interest in a telecom joint venture of Hutchison in India. VIH paid the sale consideration to the offshore Hutchison group transferor company. The Indian tax authorities were of the view that VIH was in default as no tax was withheld on the consideration paid to the transferor entity. Against a show cause notice issued by the tax authorities, VIH filed a writ petition to the Mumbai High Court.

While disposing the writ, the Mumbai High Court, among others held that:

- The transaction of transfer of shares was prima facie taxable in India since it amounted to transfer of a capital asset (controlling interest) in India. The dominant purpose of the transaction was to acquire controlling interest in the Indian joint venture company.
- The question of chargeability of the transaction to tax and the duty to deduct tax at source involves

investigation into voluminous facts and perusal of the numerous lengthy and complicated agreements which have not been produced by VIH, either before the Court, nor before the tax authorities.

Against the said judgement, VIH filed a special leave petition before the Supreme Court (**SC**). The SC referred the matter back to the tax authorities with a specific direction to the tax authorities to decide on the jurisdictional issue based on the interpretation of the agreement and in accordance with the provisions of the Income-tax Act, 1961 (**IT Act**).

SET Satellite

In the instant case, a company incorporated under the laws of Singapore undertook marketing activity in India for sale of advertisement slots for certain channels, through its wholly owned subsidiary which was its dependent agent.

The High Court held in favour of the assessee that if the correct arm's length price is applied and paid to its dependent agent, nothing further would be left to be taxed in the hands of the foreign enterprise.

LMN India Ltd

The Authority for Advance Rulings (**AAR**) in this case held that payment in the form of interest on convertible bond up to the date of conversion of bonds into equity would be characterised as interest and subject to withholding tax.

The ruling affirms that merely because interest is paid on a convertible instrument, it would not lose its character as interest.

Although rulings issued by AAR are binding only on the parties to such ruling, it could still have persuasive value and be of relevance while determining the tax treatment of interest on compulsorily convertible instruments such as debentures.

Regulatory developments

Liberalisations in FDI Policy

In order to develop the infrastructure facilities and leverage the growing business sectors, the government has gradually allowed FDI by liberalising the restrictions applicable in certain sectors viz. industrial parks, credit information companies, commodity exchange, air transport services, petroleum and natural gas, publication of facsimile edition of foreign newspapers and Indian edition of foreign magazines dealing with news and current affairs, mining and mineral separation of titanium bearing minerals and ores, etc. subject to compliance with the prescribed conditions and up to specified limits.

Recently, in an attempt to make foreign investment norms more simple and transparent, the government has come out with two press notes notifying the guidelines for (i) calculation of total foreign investment (direct and indirect) in Indian companies and (ii) transfer of

ownership or control of Indian companies in sectors with investment limits from resident Indian citizens to non-resident entities.

Further, recently the government has also issued another press note which lists down the clarificatory guidelines on downstream investment by Indian companies.

Key liberalisations in Foreign Institutional Investors (FIIs) regulations

- Non resident Indian's shall not be eligible to be registered as a sub-account.
- The type of securities in which FIIs are permitted to invest has been widened to include the schemes floated by collective investment schemes.
- The restrictions imposed on issuance of the participatory notes by FIIs have been dispensed with.
- The FII investment limit in corporate debt has been increased from US\$6 billion to US\$15 billion.
- The restrictions of 70:30 ratio of investment in equity and debt respectively by FII/sub-account have been dispensed.

Key liberalisations in External Commercial Borrowing (ECB) Policy

- ECBs up to US\$500 million per borrower per financial year has been permitted for Rupee expenditure and/or foreign currency expenditure for permissible end-uses under the automatic route.
- The Government has undertaken various other amendments in the ECB Policy such as
 - Increase in the all-in-cost ceilings;
 - Widening the definition of the term "Infrastructure sector";
 - Enabling the parking of ECB proceeds offshore as prescribed or with overseas branches/subsidiaries of Indian banks or credit to Indian rupee account;
 - Including development of "Industrial Township" as an eligible end-use;
 - Availing of ECBs by corporates in the service sector (hotels, hospitals and software sectors) under the automatic route subject to conditions, etc.

Reserve Bank of India (RBI) opens doors to venture capital funds amid liquidity crunch

News articles have reported that RBI which was holding back the applications of several foreign venture capital funds (FVCIs) has commenced clearing their applications. However, while clearing the proposals, RBI has inserted a new clause in the approval which restricts investments by these FVCIs to certain specified sectors (viz. infrastructure, biotechnology, IT related to hardware and software development, nanotechnology, seed research and development, R&D of new chemical entities in pharma sector, dairy industry, poultry industry, production of bio-fuels and hotel-cum-convention centres with seating capacity of more than 3,000) similar to those prescribed under the IT Act for availing of a tax pass-through status.

Limited Liability Partnership Act, 2008

The recently introduced Limited Liability Partnership (LLP) Act, 2008 (LLP Act) provides for formation and regulation of LLP, a new form of entity in the Indian context. Except for the designated partners, partners of the LLP have a limited liability with respect to their stake. The designated partners are liable to all penalties imposed on the LLP for contravention of the provisions of the LLP Act. The LLP is a kind of a hybrid entity combining the advantages of a partnership firm and a limited company. Such distinct

advantages may drive the entrepreneurs to structure their ventures as an LLP against other structures. The tax treatment of an LLP is still unclear and it is expected that a clarification on the same may be issued by the government.



Punit Shah
Partner

Financial Services
PricewaterhouseCoopers
India

+91 22 6689 1144
punit.shah@in.pwc.com



Himanshu Mandavia
Associate Director

Financial Services
PricewaterhouseCoopers
India

+91 22 6689 1140
himanshu.mandavia@in.pwc.com

Punit is the national leader of the Financial Services tax practice of PwC in India. He has in-depth knowledge and experience of banking and financial services laws and renders extensive professional advice to PE funds, real estate funds, venture capital funds, Indian and foreign banks, insurance companies, non-banking financial companies, mutual funds, etc.

Himanshu is a qualified Chartered Accountant with more than 10 years of experience. He is also a qualified cost accountant and company secretary. He has rendered advisory services to various large private equity funds, real estate funds, banks, NBFCs, etc. including advice on structuring of foreign investments including obtaining regulatory approvals, tax issues, exchange control matters and SEBI issues.

Japan

Rolling back the clock – proposed reforms to the taxation of private equity in Japan

On January 23, 2009, the Ministry of Finance released draft legislation to enact certain tax reforms (**2009 Tax Reform Proposal**) effective from April 1, 2009. As a whole, the 2009 Tax Reform Proposal contains several initiatives designed by the Japanese government to stimulate and revitalise Japan's domestic industries amidst the global economic crisis and the extremely tight credit markets that threaten to severely curtail foreign direct investment into Japan.

For overseas private equity (**PE**) investors, the 2009 Tax Reform Proposal heralds a welcome "roll-back" of changes implemented in 2005 to the taxation of capital gains for non-residents, as well as new provisions to allow such investors to directly invest in certain Japanese domestic PE funds without fear of being subjected to full Japanese taxation on such investments.

Generally, these reforms follow similar reforms proposed by the Financial Service Agency (**FSA**) and the Ministry of Economy, Trade and Industry (**METI**) in a joint effort to bring Japan's taxation of foreign investment into domestic companies in line with international standards, revitalise domestic industries, and facilitate further foreign direct investment in Japan to stimulate the economy.

This article is not intended to provide an exhaustive review of the 2009 Tax Reform Proposals but solely to summarise certain proposed reforms of

particular interest to the PE industry. As of the date of this article, the 2009 Tax Reform Package is being debated in the Japanese Diet and has not yet been voted on or enacted. The proposed reforms discussed herein may change. Thus, we advise that you seek further tax advice to confirm the final position and to discuss these issues, and other relevant tax considerations, before taking any action.

Current state of PE investment in Japan

In June 2006, the Japanese government announced a policy objective of increasing foreign direct investment into Japan, with a goal of doubling the overall balance of foreign direct investment to gross domestic product to around the 5% level by 2010. While investment levels increased in fiscal 2007, with the ratio approaching 3% and monthly average investment of approximately JPY 700 billion, the global financial crisis saw a severe curtailment in fiscal 2008, with monthly average investment of only approximately JPY 300-400 billion during the last five months of the year. As of September 30, 2008, the FDI/GDP ratio remained at the 3% level.

The global and domestic PE industries have been hit particularly hard, with the total value of global PE investments last year reaching a five-year low of JPY 24.16 trillion¹. In 2007, the value of such investment was at JPY 90.15

trillion by comparison². As a percentage of total global M&A activity, PE accounted for just 8% in 2008, down from almost 25% in 2006 when the Japanese government instituted its FDI goals.

While a critical factor in the severe drop-off in PE activity in Japan has been the lack of available financing, high taxation of overseas PE investment based on rules implemented in 2005 has also been widely pointed to as a significant barrier to increased FDI in Japan. As a point of comparison, studies show that currently only 4% of PE investment in Japan is from overseas capital. In the United States and the United Kingdom, jurisdictions that have more favourable rules on taxation of capital gains earned by non-residents on PE investments, the percentage of overseas capital is approximately 20% and 75%, respectively.

Development of the existing tax rules

Under existing tax rules, a non-resident PE investor generally faces two hurdles when making investments in Japan: (1) a risk of creating a taxable permanent establishment and being subject to full Japanese taxation on capital gains from investments if such investor invests into a Japanese PE fund (which most often are in partnership form); and (2) a risk that capital gains on such investments will still be taxed at a 15% or 30% level (depending on the legal form of the investor) if such investor invests into overseas PE fund, even where neither the investor nor the fund has a permanent establishment in Japan.

Permanent establishment exposure

Under general principles of partnership taxation in Japan, non-resident investors that invest in Japanese funds formed as general partnerships (*nin-i kumiai* or **NK**) or investment business limited partnerships (*toushi jigyou yugen sekinin kumiai* or **IBLP**), or in overseas partnership funds similar to NKs or IBLPs and that are deemed to have a permanent establishment in Japan, face a risk of being assessed a permanent establishment due to their investment in that partnership. This is consistent with the tax principle that partners in a partnership are deemed to be jointly doing business, with the result that a place of business in Japan of a partnership is deemed to be a

place of business in Japan (and thus a permanent establishment) for all partners in that partnership. In such case, the non-resident investors would be subject to full Japanese taxation on gains from such investments.

Capital gains taxation

A non-resident PE investor without a permanent establishment in Japan will generally not be subject to Japanese tax on any capital gain upon disposal of shares in a Japanese portfolio company unless either:

- The investor triggers the 25/5 Rule (as defined below);
- The Japanese portfolio company is characterised as a Real Estate Holding Company and the investor triggers the Real Estate Holding Company Rule³; or
- The investor has engaged in improper market manipulation (such as "greenmail").

Under what is known as the 25/5 Rule, where a non-resident investor without a permanent establishment in Japan owns or has owned (together with specially related persons) 25% or more of the shares in the Japanese corporation at any time during the 36 months prior to the last day of the fiscal year of sale, and the investor (together with specially related persons) sells 5% or more of the shares in the fiscal year of sale, then that sale will be subject to capital gains tax in Japan at a rate of 30% for corporate investors and 15% for individual investors. Triggering the

25/5 Rule will give rise to a filing obligation for the non-resident investor in Japan, unless protected under an applicable tax treaty.

Prior to April 1, 2005, the above definition of the 25/5 Rule did not contain the "specially related persons" concept for a partnership, so that the 25% and 5% ownership tests were tested in a fund context at the level of the ultimate investor if the fund was viewed as a pass-through entity (e.g., a partnership) for Japanese tax purposes. Accordingly, investors in a overseas PE fund, where the fund was a partnership in legal form, could generally assert that no investor owned more than 25% of the Japanese portfolio company so as to trigger the 25/5 Rule.

However, the acquisition of the failed Long-Term Credit Bank of Japan by a consortium led by a U.S. PE group permitted the investor group to realise over US\$1 billion in profits that escaped Japanese taxation. This resulted in significant public outrage, as taxpayer funds had been poured into the Long-Term Credit Bank of Japan to rehabilitate it out of bankruptcy. The outrage resulted in tax reforms in April 2005 by which interests of specially related persons, including partners in a partnership, were aggregated for the purposes of applying the 25/5 Rule.

For overseas PE funds in partnership form, the April 2005 changes completely changed the taxation map

for their investments into Japan, as their positions now triggered the 25/5 Rule because the ownership tests were done at the level of the fund. In response, some funds determined to base themselves in jurisdictions with tax treaties that could protect against the 25/5 Rule. Others changed their capital raising strategies to target investors who could claim treaty protection themselves from the 25/5 Rule. The industry widely perceived the April 2005 changes as significantly more restrictive than other jurisdictions⁴, inconsistent with the principles of the OECD (of which Japan is a member), and ultimately adversely impacting FDI in Japan by significantly increasing the cost of investment.

2009 Tax Reform Proposal

In a clear nod to liberalising the 25/5 Rule and stimulate foreign investment into Japan's domestic industries, METI began last summer to work with PE industry groups to come up with reform approaches to improve the taxing environment for PE investment in Japan. While various approaches were studied, the reforms ultimately contained in the 2009 Tax Reform Proposal adopt a two-fold approach: (1) providing a safe harbour for permanent establishment determinations where an overseas investor invests into an IBLP or similar foreign investment partnership fund (together **Investment Partnership Fund**); and (2) "rolling back" the 2005 tightening of the 25/5 Rule for such

investors, assuming certain criteria are met.

It should be noted that the 2009 Tax Reform Proposal remains silent with regard to the interplay of the proposal and the existing rules on taxation of real estate holding companies under the Real Estate Holding Company Rule.

Direct permanent establishment: Safe harbour rule for foreign partners in certain Japanese partnerships

Under the proposed changes, foreign individual or corporate partners (**Foreign Partner**) may invest in Investment Partnership Funds without triggering a permanent establishment in Japan on account of such investment provided certain requirements are met. These conditions include:

- The Foreign Partner has limited liability with respect to the Investment Partnership Fund;
- The Foreign Partner is not involved in the management or operation of the Investment Partnership Fund;
- The Foreign Partner's investment ratio in the Investment Partnership Fund is less than 25%;
- The Foreign Partner is not specially related to the general partner of the Investment Partnership Fund; and

- The Foreign Partner does not otherwise have a permanent establishment in Japan.

If passed, the above proposal will apply to determinations on or after April 1, 2009 in connection with whether a Foreign Partner will have a direct permanent establishment in Japan in relation to an investment in an Investment Partnership Fund.

25/5 Rule: Liberalisation for certain Foreign Partners

The 2009 Tax Reform Proposal liberalises the 25/5 Rule for certain transactions where the sale is by an Investment Partnership, assuming certain criteria are met. This reform proposes to cover transactions (**Covered Transaction**) where (1) a 1-year holding period criteria is met; and (2) the transaction does not involve a shareholding in certain distressed financial institutions.

If a transaction is a Covered Transaction, then with regard to a Foreign Partner the 25% ownership (and likely the 5% disposition threshold as well) may be tested at that Foreign Partner level instead of the Investment Partnership Fund level where the following conditions are met:

- The Foreign Partner meets the criteria provided in (1) above; or
- The Foreign Partner is in an Investment Partnership Fund where (A) the Foreign Partner does not have a permanent

establishment in Japan; (B) the Foreign Partner is a limited partner in the Investment Partnership Fund; (C) the Foreign Partner does not own 25% or more of the shares of the corporation sold; and (D) the Foreign Partner is not involved in the management or operation of the Investment Partnership Fund.

The above amendment is proposed to apply to the sale of shares on or after April 1, 2009.

Concluding comments

If the 2009 Tax Reform Proposal becomes law in its current form, this should bring Japanese taxation of PE closer in line with international standards, however, whether taxation ceases to be viewed by the industry as a barrier to increasing PE investment in Japan remains to be seen.

Chiefly, the 2009 Tax Reform Proposal does not liberalise the taxation of the general partner and related affiliates, which may cause some PE fund sponsors to continue to think carefully with regard to the existing rules. In addition, PE funds still may need to consider possible investments not falling under the definition of Covered Transactions as well as investments in the real estate holding company area. Depending on what documentation will need to be prospectively filed to claim the exemptions under the 2009 Tax Reform Proposal (still an item under negotiation as of the date of this

article), disclosure implications must also be thought through.

The 2009 Tax Reform Proposal marks a significant achievement in governmental efforts to support private business in Japan. We view this as a solid and welcome step forward for the PE industry in Japan.



Akemi Kito
Partner

Financial Services

PricewaterhouseCoopers
Japan

+81 3 5251 2461
akemi.kitou@jp.pwc.com



Marc Lim
Managing Director

Financial Services

PricewaterhouseCoopers
Japan

+81 3 5251 2867
lim.marc@jp.pwc.com

Both Akemi and Marc are core members of the funds taxation practice within PwC Tokyo and have extensive experience advising domestic and overseas PE funds and fund sponsors with regard to structuring issues and tax due diligence for PE transactions in Japan.

¹ Based on information from Thomson Reuters; translated using an average exchange rate for 2008 of 103.466 JPY/US\$.

² Based on information from Thomson Reuters; translated using an average exchange rate for 2007 of 117.814 JPY/US\$.

³ Capital gains derived by non-residents without a permanent establishment in Japan from the transfer of shares in either a listed or unlisted corporation (including certain trusts) are subject to tax in Japan where (i) such corporation predominantly holds real estate assets in Japan (**Real Estate Holding Company**); and (2) the non-resident (and specially related persons) owned more than 5% of the shares in such corporation (2% if the corporation is unlisted) at the end of the fiscal year prior to the year of sale (**Real Estate Holding Company Rule**).

⁴ Of comparable investment jurisdictions, only France has similar rules.

Taiwan

An expensive price to pay: miss-managing your tax position

In response to the recent global financial market turmoil and the potential increase to tax revenue associated with the abolition of the Statute of Upgrading Industries by the end of 2009, the Executive Yuan of Taiwan has recently proposed a tax reform package, which seeks to cut corporate income tax rate from 25% down to 20%. Further, recent changes to the Income Tax Act allow the loss carry forward period to be extended from 5 to 10 years. Executive Yuan has also decided to carry over several key tax incentives previously available under the soon-to-be abolished Statute of Upgrading Industries, including research and development (**R&D**) investment tax credits, employee training investment tax credits, international logistics and distribution centre tax incentives, and operational headquarter tax incentives.

As the aforementioned tax reform package will soon be effectuated in 2010, the more foreign investment friendly environment created in Taiwan will naturally help to attract the attention of private equity (**PE**) or other foreign investors as global economy begins its recovery journey in the near future. In this connection, we take this opportunity to outline some of the unique features of Taiwan's tax environment that may be relevant and typical to PE investors seeking investment potential in Taiwan.

Taiwan is one of the few countries in the region with a comprehensive Enterprise Merger and Acquisition Law (**EMAL**) to govern the merger and

acquisition activities conducted in its territory. However, from our practice, we still see many of the more practical merger and acquisition (**M&A**) related issues not so clearly addressed by the law. Consequently, foreign investors, including PE investors, can often be in a vulnerable position to potential tax challenges and penalties. Our experiences show that tax issues such as debt-push-down strategies, and holding company structures are some of the typical examples investment structures that need to be considered and managed cautiously.

There is currently no thin-capitalisation rule in Taiwan for tax purposes, and hence, interest on debt can always be tax deductible provided such debt is necessary for business operational needs. However, since dividends are tax-exempt income, interest on debt advanced for capital investment purpose cannot be tax deductible, and some investors have pushed debt originated for capital investment down to the acquired target in Taiwan. According to public reports, the Taiwanese tax authority is aware of such aggressive debt-push-down practices for tax purposes, and hence the relevant authorities may currently be considering regulating on this subject. It will only be a matter of time before a proper thin-capitalisation rule is promulgated; foreign investors should therefore recognise the relevant limitation imposed by the future rule when contemplating an investment in Taiwan.

Equally important to note, from Taiwanese local tax perspective, is the fact that a successful M&A deal could also depend on how well the tax position of an acquired target is managed on a day-to-day basis before as well as post deal. Prior to investing in a Taiwanese target, it is crucial for PE investors to recognise and find ways to manage the historical tax exposure a potential target may impose given Taiwan's diverse range of direct and indirect taxes.

Following from the above, once a target is acquired in Taiwan, PE and foreign investors should always be cognisant that prior tax practices adopted by the acquired target may easily be found impractical due to changes in the tax authority's detection and collection appetite. Historically, when transfer pricing regulation in Taiwan, and the neighbouring countries like China, was not so vigorously enforced, companies could focus and manage their tax affairs unilaterally. For instance, the tax authority in Taiwan previously disallowed companies claiming tax deduction on costs incurred for expatriates seconded to their related entities in China. However, the introduction of comprehensive transfer pricing regimes in Taiwan and the nearby countries like China means companies must now begin to consider and assess the potential impact of their tax practices from a multilateral angle. As such, the Taiwanese tax authority may no longer rule to disallow for example on expatriate related costs; rather, companies may now be

required to follow Taiwanese transfer pricing regulations for the employment service provided to their related entities.

Meanwhile, the Chinese tax authority is taking aggressive action on transfer pricing assessment. Hence, when more expatriates are seconded to, or more substantial functions are performed in, China, a higher profit may be required to be retained in China. The battle for tax revenue collection in different tax territories is ongoing and will continue in the future; as such, from a tax risk management perspective, investors should carefully and continuously assess not only their current investment holding structure in the region, but also the business transaction model adopted.

Familiarity with the current and future development/change of the tax environment in Taiwan is critically important to the effective management of one's tax position in the region. To illustrate, given the array of tax incentives available in Taiwan, it is important to ensure that all the historical and new conditions of any tax incentive granted are duly satisfied. Questions like "Can companies claim tax deduction and investment tax credit on R&D expenditures now if those companies, without receiving adequate remuneration (e.g., in the form of royalty), grant others (e.g., its original equipment manufacturer) the use of the R&D results for manufacturing?" are examples of the recent tax concerns arising as a result of tax authority's changing investigation focus. Companies that do not have updated

knowledge to the recent development of the law or the Taiwan tax authority's attitude will thus face certain tax exposure if the incentive is actually revoked.

Furthermore, extensive and aggressive legislation, like the recently announced anti-treaty shopping or controlled foreign corporation rules in China, put in place by governments and the tax authorities in the region, which are aimed at tackling cross-boarder tax revenue loss over the recent years, means being sufficiently knowledgeable and experienced in the current and future development of the tax environment in the region may not be sufficient to enable PE and foreign investors to pro-actively manage the tax position to their own advantages. Despite the ever stringent international tax environment, investors who can implement a more sophisticated and well-considered strategy are still able to minimise their tax position. Our experiences therefore show that a number of multi-national corporations have still managed to successfully implement strategies to actively manage their tax position whereby the ownership and control of key intangibles is decentralised and relocated to the most favourable geographic markets from both commercial and tax perspectives.

To sum up, at a broader level, Taiwan may not historically be a very attractive destination for M&A activities from tax perspective. However, the recent tax reform is soon to be effectuated, which is believed will lower the overall effective corporate tax rate to be more competitive than its neighbouring countries like Singapore, China and Hong Kong. This attraction is further enhanced by number of features currently observed in Taiwan, such as the absence of share capital gains tax and various tax incentives available, which may see Taiwan better attract foreign investments in the near future. In this regard, PE and foreign investors should recognise, and learn how to manage well, the challenges a diverse tax environment like Taiwan may present.



Elaine Hsieh
Partner, M&A Tax Leader
M&A Tax
PricewaterhouseCoopers
Taiwan

+886 2 2729 5809
elaine.hsieh@tw.pwc.com



Chun-Chih (Sam) Tseng
Senior Manager
M&A Tax
PricewaterhouseCoopers
Taiwan

+886 2 2729 6666
Ext. 23778
chun-chih.tseng@tw.pwc.com



Eric Chen
Senior Tax Associate
M&A Tax
PricewaterhouseCoopers
Taiwan

+886 2 2729 6666
Ext. 23886
eric.c.chen@tw.pwc.com

Elaine, Sam and Eric have experience in accounting, auditing, and tax consulting assignments and M&A services, including both tax structuring and due diligence work, for domestic and foreign companies.

PwC Asia Pacific Private Equity Tax Country Leaders

Australia	Mark O'Reilly	+61 2 8266 2979	mark.oreilly@au.pwc.com
China	Danny Po	+85 2 2289 3097	danny.po@hk.pwc.com
	Matthew Wong	+86 21 2323 3052	matthew.mf.wong@cn.pwc.com
Hong Kong	Nick Dignan	+85 2 2289 3702	nick.dignan@hk.pwc.com
	Florence Yip	+85 2 2289 1833	florence.kf.yip@hk.pwc.com
India	Punit Shah	+91 22 6689 1144	punit.shah@in.pwc.com
Indonesia	Margie Margaret	+62 21 528 90862	margie.margaret@id.pwc.com
Japan	Stuart Porter	+81 3 5251 2944	stuart.porter@jp.pwc.com
Korea	Han-Jun Chon	+82 2 3781 3489	han-jun.chon@kr.pwc.com
Malaysia	Jennifer Chang	+60 3 2173 1828	jennifer.chang@my.pwc.com
New Zealand	Peter Boyce	+64 9 355 8547	peter.boyce@nz.pwc.com
Pakistan	Soli Parakh	+92 21 241 6434	soli.r.parakh@pk.pwc.com
Philippines	Malou Lim	+63 2 845 2728	malou.p.lim@ph.pwc.com
Singapore	Chris Woo	+65 6236 3688	chris.woo@sg.pwc.com
Sri Lanka	Hiranthi Ratnayake	+94 11 471 9838	hiranthi.c.ratnayake@lk.pwc.com
	Richard Watanabe	+88 6 2 2729 6704	richard.watanabe@tw.pwc.com
Taiwan	Elaine Hsieh	+88 6 2 2729 5809	elaine.hsieh@tw.pwc.com
Thailand	Paul Stitt	+66 2 344 1119	paul.stitt@th.pwc.com
Vietnam	Thi Quynh Van Dinh	+84 4 3946 2246 1500	dinh.quynh.van@vn.pwc.com
Editors:	Jan-Erik Vehse	+81 3 5251 6539	jan-erik.vehse@jp.pwc.com
	Daniel Lutz	+81 3 5251 6640	daniel.lutz @jp.pwc.com

PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 155,000 people in 153 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

PricewaterhouseCoopers has exercised professional care and diligence in the preparation of this publication. However, the information contained herein does not provide a comprehensive or complete statement of the taxation law of the countries concerned. It is intended to be a general guide on issues which may interest our clients and should not be used or relied upon as a substitute for specific professional advice. While every effort has been made to ensure accuracy, no liability is accepted by PricewaterhouseCoopers or any employee of the firm on any grounds whatsoever to any party in respect of any errors or omissions, or any action or omission to act as a result of the information contained in this publication.

© 2009 PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.