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# BCM Tax

A Commentary on Banking and Capital Markets  
Tax Issues in Asia Pacific



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# Foreword



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Welcome to the first issue of *BCM Tax*, a publication brought to you by PricewaterhouseCoopers' Asia Banking and Capital Markets Tax Network.

The banking and capital markets sector has been very much in the spotlight since the onset of the global financial crisis. Besides having its role in society questioned, a number of regulatory reforms are expected following massive government bailouts. Some of these measures are tax specific, like the roll-back of banking secrecy. Others are not strictly tax measures but would nonetheless carry tax consequences. Examples of these include the unwinding of complex structures and calls to increase capital. Against this backdrop, tax professionals in financial institutions continue to navigate the myriad of tax rules across Asia Pacific, deal with tax authorities possessing vastly different levels of industry knowledge, and look out for international developments that may have an impact locally. When one lays this regulatory and tax framework over industry issues such as mobility of capital and people, it is not difficult to see the challenges tax professionals face today.

With this in mind, the lead article in this issue deals with the tax considerations arising from bankers operating on a cross-border basis, and the extent their presence or activities may inadvertently lead to the creation of a permanent establishment. It highlights the importance of recognising, on a practical level, the diversity of approaches taken by tax authorities across the region, even as international organisations try to align the taxing approach through standardised treaty interpretation. We have also included commentaries on tax developments in Asia Pacific that will have an impact on the banking and capital markets sector. It is often said that crises bring about risks and opportunities. Seeking the right balance in light of the diversity in this region, however, has never been more daunting.

We hope you will gain additional insights into the tax issues facing the industry from this publication, and we look forward to your feedback.

November 2009

# Inadvertent Permanent Establishments

## Implications for the banking and capital markets sector

### Introduction

Permanent establishment (PE) as a threshold for taxing cross border business activities of non-residents has had a long history. The recent work by the Organisation for Economic Cooperation and Development (OECD) on attribution of profits to PE has turned the spotlight back to this threshold issue. While the focus of the OECD work was on the attribution of profits and not on whether a PE exists, the discussions it generated have turned the attention of tax practitioners and tax authorities on to the question of whether a PE exists, particularly in the financial services sector to which much of the OECD work is devoted.

Financial institutions, like any other industries, have to decide on how they expand overseas. Being a regulated industry, certain segments of their business will have to be conducted through an established onshore presence, for example a branch network is usually needed for retail banking. However, given the mobility of capital, financial institutions do have some flexibility in the way they organise their business. In the field of banking and capital markets (BCM), investment banking and private banking offer two possible examples. These businesses may be run through a hub and spoke model, with centres of excellence located in one country supporting the region. It is in this context that the PE threshold issue becomes particularly relevant.

In a hub and spoke model, bankers based in one country are assigned regional responsibilities. In the course of carrying out their duties, they will pay short term visits to neighbouring countries to support transactions originating, or to service customers who are based there. These individuals will of course need to observe the banking and securities laws of the countries they visit to avoid a regulatory breach. However, even if the activities they perform locally fall within the bounds of what is permitted by the regulators, they would still need to observe local tax rules to avoid creating a taxable presence. For example, they should typically avoid concluding contracts while they are overseas. Further, their presence in those countries may be

sufficient to trigger a taxable presence through the concept of service PE if their activities enter beyond those of an auxiliary or preparatory character.<sup>1</sup>

The service PE concept, a feature of the United Nations Model Tax Convention (UN Model) that is generally favoured by developing countries, is regularly incorporated in the tax treaties of Asia Pacific countries. Therefore, financial institutions operating in this part of the world should pay particular attention to the activities of mobile bankers and the time they spend visiting clients based outside their home country to monitor if a tax exposure is inadvertently created through a service PE. The key considerations applicable in a number of Asia Pacific countries to such a business model are set out below.

### An Indian Perspective

The concept of PE has assumed a lot of significance in India for determining the tax implications of cross border transactions, as its jurisdiction tax business income under the domestic law refers to a business connection test, a concept very similar to an agency PE. In the context of Indian tax treaties, the concept of PE can be broadly divided in the following three categories:

- Fixed place of business PE
- Agency PE (other than an independent agent acting in the ordinary course of business)
- Service PE

It may be noted that all the treaties signed by India contain articles relating to the fixed place of business PE and agency PE. However, service PE is not present in all the Indian treaties, for example the India-Mauritius treaty.

India has expressed its position on a number of treaty interpretation issues in the updated edition of *OECD Model Tax Convention on Income and Capital* (OECD Model). Some of these positions seem to be contrary

<sup>1</sup> There is of course a need to consider the extent of activities carried out locally to determine the amount of profits attributable to the PE.

to the current settled interpretation. The comments given by the Indian revenue authorities could lead to substantial tax exposure as they could now interpret the tax treaties and apply the commentary to the OECD Model (OECD Commentary) in accordance with these reservations. These positions may be considered the Indian tax department's views and ideally are not binding on the courts. How they may influence the judiciary will only be known in the time to come.

Each of these types of PE along with India's position is discussed below.

### **Fixed Place of Business PE**

The essential conditions for the purpose of establishing a PE are that it should be a "fixed place of business" from which the business of the foreign enterprise should be wholly or partly carried out. By the word "fixed", what is contemplated is a reasonable continuity in the activities and linkage to the geographical location. Thus, there has to be a reasonable permanence in terms of the time to constitute a PE.

#### **India's position**

Based on the OECD Commentary, geographical and commercial coherence is a necessary element for a fixed place of business PE. India does not agree with this requirement. Accordingly, a person working in different places on unrelated contracts for short duration may be held to have a PE if the overall stay in India is for a substantial period of time.

Under the OECD Commentary, place of management, branch, office, etc. referred in Article 5(2) constitute a PE only if it satisfies the basic tests laid down in Article 5(1) i.e. permanency test, etc. India disagrees with the said interpretation and is of the view that such examples provided under the deeming fiction would constitute a fixed place of business PE.

India is of the view that a group company resident in one country which is providing services for and on behalf of another group company resident in another country, could constitute PE of the latter if the other requirements of Article 5 are satisfied.

### **Agency PE**

An agency PE will, among other things, be created when there is a dependent agent who has and habitually exercises authority to conclude contracts, or if the agent habitually secures orders wholly or almost wholly for the foreign company itself or for the foreign company and other companies controlling, controlled by, or subject to the same common control, as that company.

Whether the agent is dependent or not depends on number of factors. An agent is considered independent if the following conditions are satisfied:

- he is independent of the enterprise both legally and economically; and
- he acts in the ordinary course of his business when acting on behalf of the enterprise.

A dependent agent, on the other hand, would be subject to detailed control by the principal. He will have to act strictly in accordance with the instructions and the procedures laid down by the principal. Further, a dependent agent will generally not bear the entrepreneurial risk arising from the activities. Finally, the fact that an agent works exclusively for one principal or earns substantial part of its revenue from one principal could lead to a conclusion that such agent is a dependent agent.

There is also the issue of whether dependency should be evaluated in the context of the proposed line of services or in the context of the organisation as a whole. Recent judicial precedent suggests that the economic independence needs to be examined through a consideration of the proposed services and not the activities of the entity as a whole.

#### **India's position**

According to the OECD Commentary, mere attending or participating in negotiations, by itself, does not give rise to a presumption that such person has the authority to conclude contracts. India does not agree to this and considers, in certain circumstances, mere participation as sufficient to conclude that the person

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has exercised authority to conclude contracts. Even a person who is authorised to negotiate essential elements of the contract and not all elements and details, can be said to conclude contracts and thereby creating PE.

## Service PE

A service PE results from provision of services in India (other than services taxable as fees for technical services) through employees or other personnel for a certain prescribed period. The threshold period varies depending on whether the services are provided to a related or unrelated party. Some treaties signed by India have a threshold period of 90 days (e.g. Australia, Canada, and Switzerland) in any 12-month period. Thus this may spill over two fiscal years. The threshold is lower when the services are performed for an associated enterprise. In some of the treaties signed by India, this threshold is reduced to one day, e.g. Australia, Canada and USA.

In the context of a service PE, a view is taken that only the number of days the services are rendered should be considered and holiday, leave period etc. may be excluded. Further, judicial precedents have held that it is the solar days and not man days which should be considered.

As the treaties refer to the provision of services through employees or other personnel, there is the question of whether the term “other personnel” includes person other than individuals.

## India's position

India is of the view that for furnishing services in a country, physical presence of an individual is not essential. Taxation principle applicable to the profit from sale of goods may not apply to income from furnishing of services and taxation rights may exist even when services are performed from outside the source country by a non-resident.

With respect to this position, it may be noted the service PE clause in the treaties signed by India

states that the services should be furnished within a Contracting State which indicates that the services have to be furnished in the country for the purpose of a service PE. Accordingly, the position of India seems to contradict the wording of the treaties.

India does not agree that only profits derived from the services should be subject to tax. It is also of the view that gross amount of fees paid for the services could be an alternative to taxation of income from services.

Where a foreign enterprise outsources services to an Indian resident, supervises or directs the latter's employees who provide the services to clients of the foreign enterprise, the Indian tax authorities may also consider that a service PE is created.

## Impact on Investment Banking

In respect of cross border investment banking mandates jointly executed by an offshore team and an Indian team, one needs to apply the above principles of creation of PE and profit attribution keeping in mind the transfer pricing (TP) principles.

Traditionally, the Indian subsidiaries were compensated on cost plus mark-up basis. However, considering the significant role of Indian investment banking team, recently the profit attribution method is shifting from a cost plus mark-up basis to a revenue-sharing basis for the purpose of TP among associated enterprises.

Often the Indian subsidiary's role is confined to mere deal origination in India, the contracts with the client are signed abroad by an offshore affiliate and the execution done offshore by foreign enterprise. In such scenario, the Indian entity may be compensated adequately for the service rendered by it. In this context, it is important to note India's position on the OECD Commentary. India has not agreed to the stand taken by OECD members that merely negotiating contracts would not result in concluding contracts. Hence, even participating in negotiation, in certain circumstances, would trigger a tax exposure.

In relation to investment banking mandates signed by offshore entities with an Indian company for issue of securities, the employees of an offshore entity may visit India. In such a scenario the activities of these employees are required to be examined to determine service PE exposure for the offshore entity. Further, the activities of these employees should result in providing services to a third party. For example if the purpose of the visit is to collate information for preparing research report, then this should not create service PE exposure as the employees are not providing services to any third party. The service PE clause assumes more importance in the case of countries which have “make available” clause in the article relating to fees for technical services. Generally services which are taxable as fees for technical services do not create service PE exposure. The “make available” clause denotes that merely rendering of services is not caught unless the person utilising the services is able to make use of the technical knowledge by himself in his business or for his own benefit and without recourse to the service provider in future. In other words, the technical knowledge, experience, skill must remain with the person utilising the services even after the provision of the services has come to an end.

In some cases, the visit of the employees of offshore entities could be for services where some of these services could fall within definition of fees for technical services while some of them do not. In such cases, the question that arises is how to determine the period of stay for service PE purpose. A view can be taken that for the purpose of service PE, only the period of stay corresponding to services relevant for that purpose should be considered.

## Impact on Private Banking and Asset Management

In case of offshore entities offering their products to Indian residents, the employees of the offshore entities may visit India for marketing. If the contracts relating to investments are concluded in India, then PE may be constituted in India for the offshore entity and a part of the profit of the offshore entity would

be taxable in India. However, if such contracts are concluded abroad, then the PE exposure is low. Here again, from Indian tax perspective, care needs to be taken that the documents are executed in such a manner which establishes that the negotiation and conclusion of contracts are done abroad.

In relation to the funds of foreign investors which are invested in India, the typical structure is that the private equity fund has an asset manager abroad and an Indian company providing research services to this asset manager. Here, care should be taken that the investment decisions are not taken by the Indian company which should merely provide non-binding advice to the asset manager. If the investment decisions are taken in India, then the Indian company may be considered a place of management or an agency PE for the fund or asset manager. In this regard, the Indian position on PE exposure arising from participation in negotiation should be borne in mind.

## Practical Considerations

In the context of service PE, the Supreme Court has held that the tax liability of a non-resident entity extinguishes if an associated enterprise (that also constitutes a PE) is remunerated on an arms length basis. Relying on this decision, the Mumbai High Court in the agency PE case held that if arms length price is applied and paid, nothing further would be left to be taxed in the hands of the foreign enterprise. In this regard, it is pertinent to note that the recent *OECD Report on Attribution of Profit to Permanent Establishments* draws a distinction between the dependent agent and dependent agent PE and regards these two as separate taxable entities.

In view of the above, one needs to structure investment banking and private banking transactions keeping in mind not only the provisions of the Indian tax treaties, OECD Commentary and India’s position on the OECD Commentary but also the recent rulings on interpretation on the concept of PE and attribution of profits.

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## A Korean Perspective

### Agency PE

An agency PE will generally arise if a person in Korea has authority to conclude contracts on behalf of the foreign company and habitually exercises such authority. An agency PE will also arise if the two conditions below are met (subject to treaty relief):

- if the agent provides services mainly for a specific foreign company, regardless of whether the agent is providing such services independently in the ordinary course of its business; and
- the agent performs important business functions of the foreign company.

This is a Korea-specific rule PE threshold under which even an independent agent can be caught as an agent PE. There is no clear guidance on how to apply this provision in practice (e.g. determination of whether an agent provides services “mainly” for a specific foreign company). Due to the ambiguity in this provision, Korean tax authorities have tended to take an aggressive position in determining whether there is an agency PE or not in Korea.

### Service PE

Under Korean tax law, a service PE will exist if:

- there is a place through which an employee provides services for more than six months in a consecutive twelve month period (the “six-month rule”); or
- where services are provided for less than six months in a consecutive 12 month period, similar services are continuously and repetitively provided for two years or more (the “two-year rule”).

The two-year rule is a Korea-specific service PE threshold introduced under the Korean tax law in 2002 while the six-month rule is a typical service PE concept which has been adopted from the UN Model.

There is no clear guidance on how the two-year rule operates and, as far as we are aware, it has not yet been tested in the Korean courts. There are debates

over the scope of “similar services”, in particular, where investment bankers provide services in Korea for two years or more in respect of various investment banking projects. Some foreign banks operating in Korea argue that the two-year rule should apply on a project-by-project basis. However, the Korean tax authorities often take an aggressive approach and argue that all investment banking projects such as M&A advisory, underwriting, other advisory services are “similar” for the purpose of applying this rule.

When the tax auditors apply the six-month or two-year rules in practice, they often ask the taxpayer to provide them with the detailed records of each banker’s entry into Korea.

### Practical Considerations

#### Transfer Pricing and Advance Pricing Agreement

Based on our experience, it is not practically feasible to fully mitigate potential PE risks associated with controlled transactions. However, where the income attributable to a Korean PE is wholly accrued and reported as the taxable income of the Korean PE in accordance with a reasonable TP methodology under the Korean TP Regulations and the OECD TP guidelines, the PE risks should be significantly reduced.

In this regard, filing an advance pricing agreement (APA) would be a possible solution to mitigate a Korean PE exposure. In practice, if a taxpayer files an APA application and submits the documents requested by the Korean tax authorities, the controlled transactions subject to PE risks would not be examined in a subsequent tax audit. However, filing an APA would not provide a complete protection from PE risks as it is possible that the Korean tax authorities may scrutinise the Korean PE issues separately from the TP arrangement between related parties.

Accordingly, where it is very likely the foreign company may have a Korean PE exposure, it is advisable to reflect such PE risks into the TP arrangement and apply for an APA. In such case, a potential penalty risk can also be mitigated significantly.

Also, where a taxpayer maintains TP documentation contemporaneously and the applied TP method is determined to be reasonable, the underreporting penalty of 10% may be waived under the recently introduced penalty relief provision.

## Horizontal Monitoring System

The Korean tax authorities introduced the horizontal monitoring system effective from 2010 which provides on-going and comprehensive feedback to a taxpayer on the tax issues which have been voluntarily disclosed according to the agreement between Korean tax authorities and the taxpayer. This system is expected to reduce the uncertainty on tax issues potentially including PE issues.

However, this system is available only to qualified companies (i.e annual turnover of KRW 100 billion or more, establishment of appropriate internal control system). It is not clear at this stage whether this system is also available to multinational corporations operating in Korea.

## Self-assessment on the Personal Service Income of Foreign Companies

Foreign companies which receive the personal service income subject to the Korean withholding tax at 22% may elect to lodge a self-assessment tax return in respect of the personal service income by the end of the third month from the completion of the personal service. In this case, the expenses incurred in connection with the personal service income are allowed to be deducted in calculating the foreign company's taxable profits in Korea. The withholding tax deducted at the time of payment is creditable against the Korean tax liability.

Where the bankers of multinational investment banks perform services in Korea, advisory fees attributable to the services performed in Korea is subject to the Korean withholding tax at 22% in the absence of treaty relief. These banks may consider lodging a self-assessment tax return in respect of its Korean sourced personal service income. In this case, even if it is determined to have had a Korean PE in respect of its

Korean investment banking projects in a subsequent audit, the above-mentioned tax penalties can be mitigated significantly as the Korean sourced income has already been reported via a self assessment tax return.

## Advance Ruling System

The advance ruling system was introduced in Korea in October 2008. Where the tax implications of a transaction are confirmed by the National Tax Services (NTS) through an advance ruling, it is binding on the local and regional tax offices.

However, as far as we understand, the NTS currently does not issue advance rulings dealing with certain issues such as beneficial ownership or PE.

## An Australian Perspective

PE in Australia, including PEs in the BCM sector, is generally taxed like any other non-resident taxpayer. They are assessed on ordinary and statutory income with a source in Australia. They are generally allowed a deduction from assessable income, expenses incurred in the derivation or gaining of assessable income.

However, Australia cannot tax the profits of a non-resident that is a resident of a country with which Australia has a Double Tax Agreement (DTA), unless it carries on its business through a PE situated in Australia. Where this is the case, the business profits article, provides that profits attributable to the PE may be taxed in Australia.

It is a question of fact and degree in each case whether or not a particular business, investment, transaction or other arrangement gives rise to a PE in Australia having regard to any relevant DTA.

There are typically two bases under which a non-resident may have a PE in Australia, namely:

- by having a fixed place of business in Australia through which the business of a non-resident is carried on; or

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- by having a deemed PE in certain circumstances, including maintaining substantial equipment or where the non-resident has a dependent agent who has and habitually exercises in Australia an authority to conclude contracts on behalf of the non-resident.

However, the relevant DTA must be considered in any given case. There are many other situations where a deemed PE arises and some activities are deemed not to give rise to a PE.

The threshold PE question arises in a number of situations in the BCM sector.

Firstly, where employees of a non-resident (for example: private bankers, deal teams and investment bankers) are physically present in Australia. A PE will likely arise where the employee has a place that is used for his or her activities in Australia and it has an element of permanence, both geographic and temporal. As a guide, if a business operates at or through a place in Australia for six months or more, that place will likely create a PE. Additionally, a dependent agent PE can arise in these circumstances. Secondly, where a non-resident lessor leases an asset to an Australian resident lessee i.e. in a cross-border leasing arrangement. A deemed PE will typically arise in these circumstances. Thirdly, where there is a global trading business and aspects of the business are conducted from or involve Australia. A dependent agent PE in Australia may arise in these circumstances.

If there is a PE, then the question arises whether there is income or profits that are attributable to that PE and therefore subject to Australian tax.

In recent times, the Australian Taxation Office (ATO) has generally not actively sought to enforce the threshold PE question in Australia in the BCM sector. However, the ATO might now be focusing on this in the context of foreign private equity investment into Australia, which is otherwise generally free of Australian capital gains tax.

Rather, the focus of any ATO risk and compliance activity has typically been geared towards the amount of profits that are attributable to the PE and subject to

Australian tax. This is particularly the case in recent times as Australia's economy has held up relatively well and this has therefore presented a perceived opportunity to shift foreign losses into Australia.

Australia has a self-assessment system of taxation. Therefore whether or not a PE exists, as well as, the amount of profits attributable to that PE, is all determined by the taxpayer. The ATO manages any risks in the self assessment system through its annual compliance program.

However, in a case of uncertainty, there is a private ruling system which allows taxpayers to seek a binding ruling from the ATO that confirms whether or not a PE exists. Only then can taxpayers turn their mind to the amount of tax that must be paid by the PE.

## A Chinese Perspective

In general, under the domestic tax law in China, the business profits of a non-Chinese tax resident foreign enterprise (an "NTE") should not be subject to income tax unless it has a PE in China. If a PE is created, the China sourced profits derived by the PE, or other income that is effectively connected with the PE, would be subject to corporate income tax at 25%.

Tax treaties provide an indication on the concept of PE for Chinese tax purposes. China basically adopts the UN Model for its tax treaties. The Chinese tax authorities also refer to the OECD Model and Commentary when applying international tax concepts and interpreting specific clauses in tax treaties. In the recent past, the central Chinese tax authority, the State Administration of Taxation (SAT), had issued numerous circulars to explain its position on, and interpretation of various terms and clauses used in tax treaties.

The PE article in Chinese tax treaties generally covers a PE created through a fixed place of business, an agency PE and a service PE.

With respect to the first type, guidance provided through circulars issued by the Chinese tax authorities have indicated that a place of business belonging to

an NTE may constitute a PE, unless such activities carried out through that place are preparatory and auxiliary activities. In determining whether activities are “preparatory or auxiliary” in nature, the following would need to be considered for activities performed for head office.

- whether the fixed place only provides services to its head office or whether it has business transactions with other parties;
- whether their business nature is identical;
- whether the business operations of the fixed base constitute an important part of those of its head office.

As regards the concept of service PE in China, the threshold commonly refers to a period or periods aggregating more than six months within any twelve-month period.

In circulars issued by the Chinese tax authorities, it has been clarified that the six-month period will start from the first day the overseas employees enter China and end on the last day they depart China on completion of the project. During this period, if no employees are present in China to provide services for a consecutive period of 30 days, one month can be excluded from the period in counting the six-month period for PE purposes. Based on this counting method, a day spent by an employee in China will be counted as “one month”. If the time spent by all employees spread over a period of more than six months, a foreign company will be regarded as having PE in China even though on an actual basis, the total time of their physical presence in China may be less than one month.

While the Chinese tax authorities have maintained its stand on how the six-month PE threshold should be determined, they have acceded to request from treaties partners to modify the service PE rule. Its tax treaties with Hong Kong, Singapore and Belgium have been updated to reflect a threshold for service PE of “183 days in any twelve-month period”, making it easier for foreign enterprise to manage and monitor

their project to avoid creating a taxable presence. It remains to be seen whether the Chinese tax authorities would update all treaties with similar wording in re-negotiating the DTAs, or it would make the change only if the treaty partners raise it.

## **New tax administration environment**

From 2009 onwards, foreign service providers or contractors who provide services in China are required to perform tax registration. Hence, they will have Chinese tax filing obligations irrespective whether a PE has been established. In addition, for NTE that has established a PE in China and would file tax returns for their taxable income determined on actual basis, they are required to disclose their related party transactions as part of their annual Chinese tax filing. Through imposing such compulsory compliance requirements, the Chinese tax authorities hope to have increased control and enforcement of taxation of NTE.

The SAT also addressed, through tax circulars, how NTE may claim tax treaty benefits, including PE protection. The new rule has clarified that treaty benefits will not be granted if the treaty residents or their withholding agents fail to comply with the prescribed procedures.

## **Practical considerations**

Until recently, there has not been a formal and systematic framework for taxpayers to apply to the Chinese tax authorities for PE assessment or exception. The assessment of PE issues and related tax implications are largely based on a case-by-case assessment by the in-charge tax bureaus. This has resulted in different interpretations and practices by each tax bureau.

Except for the international taxation division of the SAT and tax bureaus in major cities of Shanghai, Beijing and Shenzhen, some local tax bureaus (especially those in inland China) are not familiar with international tax concepts. In certain cases, they have sought direction from SAT on reviews of PE issues.

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In the past, where a foreign enterprise has created a PE in China, the Chinese tax authorities' practice is to adopt a deemed profit method to determine the China sourced profits. The deemed profit rate ranges from 10% to 40% and the final rate is subject to negotiation and agreement.

Based on the new administrative circulars issued, the situation seems to be changing. The circular prescribes that a NTE with PE created in China should be taxed based on their actual profits attributable to the PE. In making this determination, the Chinese tax authorities may refer to the recent OECD work on attribution of profits to PEs as guidance although China is not part of OECD. Hence, we anticipate a growing reliance on TP to be used as a resolution between the Chinese tax authority and taxpayer to determine the profits attributable to a PE in China.

An alternative method that taxpayers could consider is advance ruling. Although there have not been many reported cases, it offers an alternative for foreign enterprises to obtain certainty on the related party transactions and on the tax implication of their business presence in China.

## A Malaysian Perspective

Malaysia imposes tax on the basis of source including whether a PE exists. However, the concept of PE would be relevant in the context of business profit derived by a foreign enterprise residing in a country with which Malaysia has concluded a treaty. In such a case, the business profits of the non-resident enterprise would only be taxable in Malaysia if it has a PE in Malaysia to which those profits are attributed. Besides the usual fixed place of business PE and agency PE, most Malaysian treaties incorporate the service PE concept, e.g. the Malaysia-Australia treaty.

Normally, the PE issue which arises for the BCM sector relate to foreign bankers being present in Malaysia providing services to Malaysian companies. There is a need to ensure that the employees of the foreign banks who fly into Malaysia do not create a PE for the banks in Malaysia. In addition, there is a need

to consider stockbrokers and investment advisers in Malaysia and ensure that the trading that they perform for their counterparties do not result in a PE in Malaysia through any rights provided to these service providers in Malaysia.

Special consideration should also be given to joint ventures entered into between foreign banks with local Malaysian banks. Where such joint ventures involve the employees being present in Malaysia, there is a need to ensure the time threshold in tax treaties are not breached. In addition, where the fee payable to the foreign bank is through a profit-sharing agreement, there is a risk that the tax authorities may view such profit-sharing agreement to be a partnership and seek to tax the foreign bank's share of profits. This is so notwithstanding that the time threshold is not breached. In most instances, a technical services arrangement could be considered instead, so that the fees paid to the foreign bankers are subject to the 10% withholding tax when the services are provided in Malaysia. It is also important that the time threshold in tax treaties is carefully monitored and for the employees who provide the services in Malaysia not to be provided with rights to conclude contracts while they are in Malaysia.

## A Taiwanese Perspective

The term PE is not specifically defined under Taiwan's domestic tax laws. However, in practice the tax authorities generally regard a foreign entity with a "fixed place of business" or a "business agent" in Taiwan as having a PE in Taiwan. Both terms are defined in the legislation and there are various public rulings providing specific circumstances that may be subject to Taiwan taxation (or not).

The concept of service PE is also seen in several tax treaties entered into by Taiwan (for example, Australia, the United Kingdom and the Netherlands) where a foreign company furnishes services through its employees in Taiwan for a period or periods of a certain number of days or months. However, the way the Taiwan tax authorities regard PE presence is similar to the principles articulated in the OECD Model.

## Impact on Banking

As international transactions are now simply an every day business necessity, mobile bankers flying into Taiwan should observe the activities that they perform in Taiwan and their length of stay in Taiwan to avoid inadvertently creating a service PE in Taiwan.

In many cases, mobile bankers (particularly senior ones who are possibly Taiwanese nationals) are often directly involved in marketing, deal initiation and negotiations. Generally speaking, there would be a potential PE risk in Taiwan if these bankers:

- have general authority to conclude transaction on behalf of the bank;
- visit Taiwan on a regular basis for marketing and/or deal origination purposes;
- utilise offices/facilities of Taiwanese branches or affiliates in Taiwan.

In particular, the Taiwan tax authorities are now more proactive and have taken a much more aggressive approach to applying taxation rules on the income paid to foreign companies.

In general, a foreign bank with a fixed place of business or business agent in Taiwan is required to file a tax return to report its revenue and pay income tax at the prevailing income tax rate. In addition, the fixed place of business or business agent of the foreign bank should keep separate accounting books and has the obligation to file tax return on behalf of the foreign bank. On the other hand, where the foreign bank does not have a fixed place of business or business agent in Taiwan, the Taiwan-sourced income derived by the foreign bank should be subject to withholding tax.

In addition, the force of attraction rule applies where the foreign bank has a Taiwan branch and receives income directly from other Taiwanese entities (even without the Taiwan branch's involvement). The Taiwan branch is required to maintain separate accounting

books and file tax return on behalf of the foreign bank if the bank derives Taiwan-sourced income. In this case, the foreign bank may claim tax deduction for offshore expenses incurred, as long as they are supported by evidential documents (e.g. audited financial reports and cost allocation schedule etc, authenticated by the embassy, consulate or representative of Taiwan).

Once a PE presence is established, it is necessary to determine the amount of income that should be brought to tax. In general, a foreign entity deriving Taiwan-sourced income will be subject to Taiwan income tax assessment and these include various types of income including service fees, business profits and the catch-all provision, other income.<sup>2</sup>

If the foreign bank does not derive any Taiwan-sourced income, in principle there should be no Taiwan income tax assessment even if the foreign bank has a PE in Taiwan.

## Practical Considerations

The ideal solution in mitigating PE risk is monitoring the activities carried out by mobile bankers. Many banks nowadays have manuals providing guidance on the “do’s” and “don’ts” for cross-border activities, for example mobile bankers should not conclude contracts on behalf of foreign bank, take part in the pricing of contracts, and they should avoid the use of any Taiwanese address or contact information.

But in reality, the tax authorities may not necessarily agree (or even believe) that no service PE is formed especially when mobile bankers travel to Taiwan on a regular basis and perform marketing activities, which is an area of uncertainty when determining whether there is any Taiwan-sourced income being derived.

Tax treaties do provide relief to a certain extent but that depends on the type of income concerned. Unfortunately Taiwan does not have a very wide comprehensive tax treaty network. Currently Taiwan

<sup>2</sup> On 3 September 2009, the Taiwan tax authorities issued a new interpretation of what is regarded as Taiwan-sourced Income through the Guidelines on Determination of Taiwan-sourced Income under Taiwanese tax legislation. Please refer to the article on Taiwanese Tax Developments.

# Inadvertent Permanent Establishments

has signed tax treaties with 16 jurisdictions and does not have tax treaties with key jurisdictions (e.g. the United States, Hong Kong) from which major investment banks are headquartered.

Foreign banks with PE in Taiwan may actively manage its tax risk by considering several alternatives. First, income tax exposure could be limited by having appropriate TP arrangement for the service PE and this should be substantiated by proper documentation. These may include various evidential documents to support claims of expenses, TP report, service agreements, etc.

Second, it may enter into an APA, though this may not be a preferred option. The threshold amounts involved should be substantial before it should be explored given the significant resources involved in APA negotiations.

Though substantially most income would be subject to income tax assessment at the prevailing corporate income tax rate (currently 25%, to be reduced to 20% for the fiscal year commencing 2010), the final tax burden can be partially alleviated by applying for the “deemed profit” method, where the taxable income of the PE is calculated based on a profit level indicator and then subject to the corporate income tax rate. For example, the 2007 financial year profit level of 28% was announced for securities firms. Hence, the effective income tax rate is only 7% (28% profit level at 25% income tax rate).

All in all, it is still possible to plan or structure a transaction in a way that a foreign bank or securities firm does not create a PE in Taiwan. Even if a service PE is created, there are several options to explore lowering the tax burden to an optimal level.

## Indirect tax implications

Apart from the above, there is a need to consider the indirect tax implications from the creation of an inadvertent PE. The exact tax implications would depend on the specific jurisdiction and its legislation. For example, a country with a value-added tax regime may require compulsory registration if the (foreign) service provider is treated as belonging to the country by virtue of services rendered through a business establishment in that country.

## Concluding remarks

The basis for bringing non-residents to tax varies from country to country. Some impose tax on the basis of source, while others refer to the concept of a PE in their domestic law. Some consistency in approach is brought about through tax treaties, under which a non-resident should not be subject to tax in a source country on its business profits, unless it has a PE in that country and those profits are earned through the PE. Having said that, there is no uniformity of PE threshold, nor in the approach to managing PE risk, across Asia Pacific.

In the BCM sector, the concepts of agency PE and service PE are particularly relevant, given the business model adopted by certain lines of business where bankers operate on a cross border basis. These models should be carefully calibrated to ensure that the relevant PE thresholds (whether under domestic law or tax treaties) are observed. Managing this issue proactively, whether through transfer pricing, advance pricing agreements or taking advantage of domestic law exemptions, is central to avoiding the unintended direct and indirect tax consequences arising from the creation of an inadvertent PE.

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# North Asia

People's Republic of China

Japan

Korea

Taiwan

# People's Republic of China

## Developments in foreign invested Renminbi private equity funds in China



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A wave of foreign buy-out firms has announced their plan to launch Renminbi (RMB) private equity funds in China during the month of August 2009. It was reported in the news that Blackstone signed a memorandum of understanding (MOU) with the Shanghai Pudong government to establish their first RMB fund in China. Thereafter, announcements have been made by a number of private equity (PE) houses including Prax Capital, Macquarie, CLSA and First Eastern. All these foreign PE houses have selected to launch their new RMB funds in Shanghai, reflecting the country's efforts in attracting the PE industry as part of its ambition to become a global financial hub by 2020.

Under Shanghai's new pilot policies, the first step for these foreign PE firms to establish their RMB fund platform is to form an investment management enterprise (IME) which requires a minimum capital of US\$2 million. This IME takes the form of a foreign investment enterprise (FIE) and can be wholly owned by the foreign buy-out firms.

With this IME vehicle, the PE firm may proceed with the establishment of the RMB fund platform in the form of a domestic limited liability partnership (LLP) with

the IME to be approved as the general partner of the fund whereas other investors can participate as limited partners.

The key advantages of this emerging RMB fund structure are:

- Speedier transaction cycles through simplification of approval process for onshore deals.
- Establishment of the LLP fund structure does not require prior approval from the Ministry of Commerce.
- Ability to raise capital from domestic investors.
- Capturing the emerging trend to exit from China portfolio investment through the domestic IPO Market.
- Certainty on the tax pass-through status thus eliminating taxes at the fund level to avoid double taxation on fund and the underlying investment.
- Local incentives and subsidies to be granted to the IME and its local management team.

There are a number of issues that need to be resolved to ensure smooth operations of this emerging RMB fund structure:

- Restrictions on foreign capital conversion for capital injection into the LLP RMB fund either by the foreign invested IME or foreign limited partners.
- Whether this LLP RMB fund structure allows participation by foreign limited partners.
- If foreign limited partners are allowed to participate in this RMB fund structure, what is the tax regime for the foreign limited partners and whether such foreign partners can apply relevant tax treaty benefits to protect their capital gains from Chinese tax or restriction of foreign capital conversion?

The State Administration of Foreign Exchange (SAFE) circular 142 explicitly restricts an FIE from converting

its registered capital from foreign currency to RMB for equity reinvestment. This essentially prevents the IME vehicle from bringing foreign capital into China and converting it to RMB for its capital contribution to the RMB fund. It remains to be seen how the Shanghai government can introduce a scheme to develop a new route to overcome the problem created by SAFE circular 142 on registered capital conversion.

### **Foreign participation restriction on RMB Fund**

One of the key obstacles for foreign PE firms to adopt the LLP structure for their RMB fund vehicle is the uncertainty in foreign investors becoming the limited partners (LPs) of this LLP structure. In the past, the Chinese partnership law only allows domestic entities and individuals to participate as LP in the LLP structure. However, it has been reported that the State Council has approved a new set of the foreign invested partnership regulations on 19 August 2009. This newly approved foreign invested partnership regulations bring hopes and excitement for foreign investors to participate as LPs in the RMB funds organised as a LLP.

### **Taxation of foreign partners in the RMB Fund**

Given the RMB fund can secure a tax pass-through treatment from the local tax authority, the next issue 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 fund will have much heavier tax burdens on the distributions from the funds (i.e. 25% corporate income tax) if they are considered as having a permanent establishment in China. On the other hand, if they have not created a permanent establishment in China, their share of income from the fund will only be subject to 10% PRC withholding tax. Therefore, it is in the interest of the foreign partners in the RMB funds to limit their presence in China to reduce their China tax exposure. The PRC

tax authorities may consider the foreign partners to have a taxable presence if their partners are seen to carry out investment management activities in China for the fund. Accordingly, RMB funds which intend to minimise the Chinese taxation of its foreign partners must observe strict operating guidelines so that the foreign partners are not involved in managing the operation of the RMB fund.

As Chinese regulators continue to push for laws creating a more favourable investment landscape for private equity and venture capital sectors, the RMB fund structure has become an emerging solution to the industry players.

However, uncertain tax rules in China for these funds may create additional layers of taxation to the foreign private equity houses, thus affecting the after-tax return of the investors. The need to perform a tax review before the funds' closing is of paramount importance.

# Japan

## Treatment of capital in Japan financial services transfer pricing



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Treatment of capital, or compensation for the role of capital, in transfer pricing has been a difficult issue in recent years in Japan, and one of the most common areas of disagreement between the tax authority and taxpayers. In the Tax Tribunal's decision on 2 July 2008 in a case involving a Japanese branch of a foreign financial institution, we get a glimpse of the Japanese tax authority's current thinking of the role of capital (although a substantial part of the Tribunal's decision is redacted).

The taxpayer filed the appeal to the Tokyo Tax Tribunal on a transfer pricing assessment in connection with its equity derivatives business, based on the grounds that its affiliated foreign booking entity should be compensated for the provision of capital. The Tax Tribunal's decision partially reversed the assessment originally made by the Tokyo Regional Taxation Bureau (TRTB).

The outcome and the analysis in the decision as summarised in this article represent the views of the Tax Tribunal, which is part of the National Tax Agency, but do not represent the views of the courts given Tax Tribunals are outside of the judicial system. However, in future audits the tax examiners may well refer to or consult with this case where the facts and circumstances are similar.

### Facts

This case involved an original assessment made in 2005 by the TRTB against a Japanese branch of a foreign company for its taxable years from 2000 to 2003. The subject dealings/transactions were among the Japanese branch, its head office and its affiliates. The customer transactions were booked in a non-Japanese entity, and their risks were managed on a global basis. The following four functional areas in the business were considered:

- trading;
- market risk management;
- sales and marketing; and
- other functions (data input, transaction documentation, settlement, legal, credit research, and accounting).

The countries involved were not disclosed. However, the Tokyo, London and New York stock exchanges were mentioned. The taxpayer's transfer pricing method appears to be based on a method akin to

the so-called hedge fund model. When applied to a capital markets situation, the hedge fund model would typically allocate anywhere between 10% to 25% of profits to entities engaged in trading activities, with the remainder of the profits being allocated to the booking location. In this case compensation for sales and marketing and other functions (i.e., functions (iii) and (iv)) was not disputed between the taxpayer and the TRTB, and was deducted in deriving the profit to be allocated between the trading and booking locations, i.e., the “residual” profit. The assessment by the TRTB was based on the residual profit split method, under which the residual profit was split based on relative contribution to the business, measured only by traders’ compensation.

## Tax Tribunal’s Decision

The Tax Tribunal also utilised the residual profit split method, as with the original assessment. However, in addition to traders’ compensation as a measure of relative contribution to the business, the Tax Tribunal added interest expense calculated on the capital used for the business, to measure the relative contribution made by the functions performed by risk managers. The Tax Tribunal rejected an argument used as support in the original assessment that the business is primarily based on customer trades where no significant market risk is involved. Instead, the Tax Tribunal recognised that the business primarily related to proprietary transactions, on which a significant part of the profits of the business were earned, and therefore market risk was relevant to the business. As a consequence, in order to acknowledge the importance of the market risk management function, along with the trading function, the Tax Tribunal added the interest expense to the measure of relative contribution. The interest expense was calculated using the ratio of interest expense to liability on an overall group level. Accordingly, the TRTB’s decision was partially reversed insofar as it excluded any additional measurement for relative contribution based on the market risk

management function. In the selection of the transfer pricing method and its application, the Tribunal’s decision only referenced the laws relating to transfer pricing in general, and not the laws relating to attribution of income to branches of foreign corporations.

The Tax Tribunal rejected the hedge fund model. Their view was that the split of profit under a hedge fund arrangement is based on a hedge fund investor’s entitlement to profit in return for assumption of high risk, the nature of which was different from that of the taxpayer’s equity derivatives business. As such, the split of profit under a hedge fund arrangement was not an indication of relative contribution as specified under the Japanese transfer pricing rules in the application of the profit split method to the taxpayer’s equity derivatives business.

The Tax Tribunal also rejected the use of weighted average cost of capital (WACC) as a way to determine funding cost. It viewed that the component of WACC related to the cost of equity is a theoretically calculated expected return to investors, and not an actual expense, and that such data lacks objectivity and certainty.

The above decision did not directly address the role of capital but instead focused on risk management function: this illustrates that a discussion surrounding the role of capital is still a difficult topic to pursue with the Japanese tax authorities. On the other hand, the fact that a certain measure of contribution based on capital was recognised in the decision may be significant in the application of the residual profit split for Japanese transfer pricing purposes. Lastly, a rejection of the use of the hedge fund model (particularly in this case where proprietary trading was prevalent) and a rejection of the use of WACC indicate potential sources of tax disputes on those topics in the future.

# Korea

## Recent tax developments in Korea



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### Foreign exchange rates used in translating foreign currency denominated borrowing for the purpose of applying the thin capitalisation regime

Under the amended thin capitalisation regime effective from the tax year ending 31 December 2009, the Korean branches of foreign banks may elect to calculate the amount of foreign currency denominated borrowing for the purpose of thin capitalisation regime using either (i) the daily foreign exchange (FX) rate or

(ii) the FX rate at year end. Prior to this amendment, only the FX rate at year end should be used for the purpose of thin capitalisation regime. Once the election is made, the elected method must be applied for the following five years.

This amendment is intended to mitigate the detrimental tax impact that could arise from turbulent fluctuation of the FX rates to the Korean branches of foreign banks in applying the thin capitalisation regime. Therefore, this amendment is expected to allow the Korean branches of foreign banks to effectively monitor its thin capitalisation position during a year.

### Exemption on Korean government bonds

A foreign company is exempt from tax on both interest and any capital gain arising from investment in government bonds and monetary stabilisation bonds according to the newly enacted Article 93-2 of the Corporate Income Tax Act which is effective from 21 May 2009.

In order to claim an exemption under Article 93-2, a foreign company is required to lodge an application for tax exemption via a local withholding tax agent by the ninth day of the month following the month to which the first payment date belongs. Either (i) a tax resident certificate or (ii) the documents announced by the Commissioner of the National Tax Service (NTS) are required to be lodged together with the application. The statement on the holding period of the bonds is required to be lodged as well. According to the notice issued by the Commissioner (2009-96, 2 September 2009), the documents allowed to be lodged in lieu of a tax resident certificate are as shown in Table 1.

A foreign company investing into the Korean government bonds through a qualified foreign financial institution located in a treaty jurisdiction is also allowed to claim an exemption under Article 93-2.

Table 1

Classification	Documents
Individuals	A copy of passport, other identification documents issued by the government
Corporation (including corporate type fund)	Court registration certificate or other documents issued by the government confirming the name and address of the corporation
Government institution, pension fund, etc.	Documents issued by the government confirming the identity of the investors
Public collective investment vehicles	For the vehicles considered as public funds in the location of its establishment, the documents substantiating that they are public funds (e.g. fund registration certificate, documents issued by the financial authorities, etc.)  For other vehicles with 50 or more of investors, fund registration certificate and prospectus, etc. which substantiate that 50 or more of investors are solicited
Private funds	The above documents for the investors and beneficiaries
Partnership	The above documents for the partners

This exemption is expected to increase the attractiveness of the market for Korean government bonds and monetary stabilisation bonds for foreign companies.

### Abolishment of exemption of gain from foreign stocks of domestic funds

Tax exemption on gains from sale and valuation of foreign listed stocks invested by domestic funds will be abolished after 31 December 2009. However, a loss from sale and valuation incurred up to 31 December 2009 is allowed to be deducted from any gain derived during the period from 1 January 2010 to 31 December 2010. This transition provision allows the investors to avoid being taxed on the recovery of loss in 2010 where the investment in a particular stock by the fund suffers an overall loss for the entire investment period.

### Introduction of Islamic finance tax regime

The Korean government will introduce an Islamic finance tax regime from 1 January 2010. Sukuk Ijara and Sukuk Murabahah structures whereby an offshore special purpose vehicle set up by a Korean company that issues non-Korean Won denominated Sukuk are

eligible for tax benefits. The tax benefits include (i) re-characterisation of the underlying cash flow (i.e. rental income, difference between the acquisition cost and on-sale price) as interest eligible for tax exemption, (ii) deferral of capital gains and (iii) tax neutrality provision applicable to the transfer of underlying assets for the purpose of Korean transaction taxes.

It is expected that the Islamic Finance tax regime will help Korean companies attract capital from Islamic investors by eliminating the tax hurdles which investors would otherwise face.

### Withholding tax on the bond interest received by financial institutions

The bond interest received by financial institutions will be subject to 14% withholding tax from 1 January 2010. Currently, the interest received by financial institution is exempt from the withholding tax. However, there should be no final tax effect since the withholding tax will be deducted from the tax payable or refunded through the tax return. This amendment has been introduced as part of the government's efforts of reducing public deficits in 2010.

# Taiwan

## New tax treatment of financial products



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Year 2009 sees several tax developments affecting the banking and capital markets industry. All these mainly aim to standardise tax treatments and to implement a fair tax system. Some recent developments in the general tax environment offered favourable tax treatments that may have direct influence on banks, including the reduction of corporate income tax rate, the extension of loss carry-forward period, the revision of Assessment Rules of Profit-Seeking Enterprise Income Tax which now offer more relaxed tax deduction rules on certain expenses, and the long-awaited release of Guideline for Determination of Taiwan-Sourced Income.

### Amended taxation on financial products

To ensure consistency in tax rates applied on financial products, Articles 14-1, 24 and 24-1 of the Income Tax Act (ITA) were revised on 22 April 2009 to set out new tax treatments for interest income derived from short-term commercial bills, securitised products issued under the Real Estate Securitisation Act and the Financial Asset Securitisation Act, structured products and repo transaction for individuals and profit-seeking enterprises from 1 January 2010 onwards.

According to the amendment, for individual investors, a 10% (previously at 20% or 6% as the case may be) final withholding tax rate is applicable on income derived from all financial products mentioned above. As for corporate investors, the interest income will be included in the tax return and subject to prevailing corporate income tax rate.

A comparison of taxation on financial products before and after the amendment is set out in Tables 1 and 2.

In addition, a tax ruling was issued on 27 August 2009 to provide further clarification on the tax treatment for financial products which were issued prior to 2010 but will be due on or after 1 January 2010. In general, interest income paid after 31 December 2009 will be subject to applicable withholding rates based on different categories of the recipient's identity, with the exception of certain interest income paid by clearing institution or Central Bank.

### Amendment to the Standards of Withholding Rates for Various Incomes announced by the Ministry of Finance

In response to the revised ITA, an amendment to the Standards of Withholding Rates for Various Incomes ("the Standards") was announced by the Ministry of Finance (MOF) on 28 October 2009.

Significant changes to the amendment affecting financial services industry include revision of withholding tax rates on interest for various financial products and other income. The key amendments are summarised in Table 3.

The amended Standards will be effective from 1 January 2010.

Table 1

Individual Investors				
Financial Product	Before Amendment		After Amendment	
	Method of Assessment	Tax Rate	Method of Assessment	Tax Rate
Short-Term Commercial Bill	Assessed on Withholding Basis	20%	Assessed on Withholding Basis	10%
Securitised Products	Assessed on Withholding Basis	6%		10%
Structured Products	Included in Annual Tax Return	6%~40%		10%

Table 2

Corporate Investors				
Financial Product	Before Amendment		After Amendment	
	Method of Assessment	Tax Rate	Method of Assessment	Tax Rate
Short-Term Commercial Bill	Assessed on Withholding Basis	20%	Included in Annual Tax Return	25%
Securitised Products	Assessed on Withholding Basis	6%		25%
Structured Products	Included in Annual Tax Return	25%		25%

Table 3

Type of income		Withholding rate	
		Resident	Non-Resident
Interest	Short-term bills	10% (originally 20%)	15% (originally 20%)
	Beneficiary or asset-backed securities issued pursuant to the Financial Asset Securitisation Act and the Real Estate Securitisation Act	10% (originally 6%)	15% (originally 6%)
	Repo trade in instruments mentioned above, corporate bonds, government bonds or financial bonds.	10%	15%
Other income	Income from structured products with securities firms or banks	10%	15%

## Potential tax savings based on new interpretation of Taiwan-sourced income

For years, the National Tax Administration (NTA) has deemed fees paid for services rendered to foreign service providers but utilised within Taiwan as Taiwan-sourced income which would be subject to withholding tax, regardless where the services are rendered.

The broad view taken by the NTA in general made it more expensive for multinational companies to transact with Taiwan companies. Finally on 3 September 2009, the Guideline for Determination of Taiwan-Sourced Income under Article 8 of the Income Tax Act (the Guideline) was issued, which gave a new interpretation for determining whether income is Taiwan-sourced or not.

Highlights of the Guideline are as follows:

- The location where services is rendered is the determinant of Taiwan-sourced income, not where the services are utilised. Service fees paid for services rendered purely offshore are not deemed as Taiwan-sourced. For services partially rendered in Taiwan or with local involvement and assistance, the income shall be deemed Taiwan-sourced.
- Business profits should be segregated into onshore and offshore portion based on contribution level. Only the onshore business profits will be regarded as Taiwan-sourced income.
- Income comprising various income types shall be classified into the appropriate categories (i.e. royalties, service fees or rental, etc.) based on the income nature and taxed accordingly.
- Withholding tax generally applies to Taiwan-sourced income. However for certain types of income (e.g. remuneration for services rendered, rentals, business profits, and other income), the foreign enterprise may appoint a tax agent in Taiwan to claim tax deduction for expenses incurred and apply for a tax refund within five years from the date of payment. Foreign enterprise can file the application for each withholding tax payment or for aggregate income derived in each taxable year.

## Reduced corporate income tax rate to 20%

In response to the impending expiration of the “Statute for Upgrading Industries” by end of 2009, various revisions to the ITA were passed by the Legislative Yuan during the year 2009.

Significant changes as a result of the revision include the following:

- The corporate income tax rate will be reduced from 25% to 20% for fiscal year beginning 2010.
- The loss carry forward period is extended from five years to 10 years, with all other conditions remaining unchanged.

For companies in loss position, there may be a need to look into the deferred tax calculation.

## Regional allocated costs now tax deductible

The Taiwan branch of a foreign enterprise may now claim a tax deduction for regional head office allocated general and administrative expenses, in addition to the head office allocated general and administrative expenses. The methodologies available for allocating the general and administrative expenses and documentation requirement to support the claim remain unchanged with the amendment. Hence, foreign banks with regional offices (commonly in Hong Kong or Singapore) may now consider allocating reasonable amounts of regional head office expenses to their Taiwan branches. Apart from direct potential tax savings for the Taiwan branch, the regional office may now actually recover part of its regional expenses incurred in relation to the Taiwan branch and these tax-deductible regional office expenses are also free from withholding tax.

## Elimination of double taxation on sub-brokerage fees

To eliminate the double taxation on sub-brokerage fees paid to foreign securities firm, Tax Ruling Tai-Tsai-Shuei No. 09804529880 states that the brokerage fees earned by domestic financial institutions shall be subject to a 2% business tax, while the remainder of the fees (i.e.

sub-brokerage fees) subsequently passed on to foreign securities firms will be subject to 5% business tax. This is so provided that a contract is established with the investors stipulating that the sub-brokerage fee received by the domestic securities brokerage firm is for and on behalf of the foreign securities firm. Previously, the sub-brokerage fees paid to foreign securities firm were also subject to 2% business tax.

Taiwan investors engaged in such transaction will be deemed as the purchaser of services provided by foreign securities firm, and pursuant to Article 36 of Business Tax Act, it shall be liable for business tax levied on the sub-brokerage fees. However, the said business tax may be payable by the domestic securities brokerage firm on behalf of the Taiwan investors.

Table 4 illustrates the elimination of double taxation on the sub-brokerage fees following the implementation of the Ruling.

Table 4

Business taxes assessed upon	Before issuance of Ruling 09804529880	Tax Ruling # 09804529880
Receipt of gross payment (X = X1+X2) from Taiwan investors	(X1+X2)*2% (payable by domestic brokerage firm)	X1*2% (payable by domestic brokerage firm)
Forwarding of sub-brokerage fee (X2) to offshore securities firm (Brokerage firm's perspective)	X2*5% (payable by domestic brokerage firm)	
Forwarding of sub-brokerage fee (X2) to offshore securities firm (Investor's perspective)		X2*5% (payable by investors)

### Detachable warrants subject to 0.1% securities transaction tax

Following the regulatory amendment on 27 May 2009 to allow the issuance of detachable warrants with domestic preferred shares and corporate bonds by listed or OTC companies, the MOF clarified that warrants that are detachable from preferred shares or corporate bonds shall be subject to 0.1% securities transaction tax (STT).

The STT for preferred shares and corporate bonds would remain the same, i.e. preferred shares will be subject to STT at 0.3% while corporate bonds are currently exempted from STT in accordance with the Statute for Upgrading Industries.

Table 5 illustrates the applicable STT on detachable and non-detachable warrants following the above amendment.

Table 5

Type of securities	Non-detachable warrants	Detachable warrants
Preferred Shares	Taxed as a whole at 0.3%	0.3%
Warrants		0.1%
Corporate Bonds	Exempt from STT*	Exempt from STT*
Warrants		0.1%

\* Article 20-1 of Statute for Upgrading Industries.

## Proposed standardisation of business tax for foreign financial institutions and addition of tax exemption on de minimis payment of foreign service

Amongst the various business tax reforms proposed by the Executive Yuan, on 2 July 2009, the proposed amendments to Article 36 of the Business Tax Act would affect financial services directly. Financial institutions refer to companies engaged in the business of banking, insurance, investment trust, securities, futures, commercial paper and pawn-broking.

The first amendment standardises the business tax rate to 2% on financial services (for exclusively authorised businesses) rendered by foreign financial institutions regardless whether it has a fixed place of business in Taiwan.

The second amendment exempts business tax on service fee paid to a foreign entity in one payment which is below the prescribed limit to be announced by the MOF.

The proposed amendments are still under review. Table 6 illustrates the current law and the proposed amendments

## Securities transaction tax exemption on corporate and financial bonds proposed to be continued

The current STT exemption on corporate and financial bonds is due to expire on 31 December 2009.

With the aim of developing the capital and bond market, it has been proposed that the exemption period be extended for another seven years.

The proposed extension is currently under review.

Table 6

	Current Law	Proposed Amendment
1. Business tax rate applicable to foreign entity* for services provided:		
- Foreign financial institution**		
i. Exclusively authorised business	5%	2%
ii. Non-exclusively authorised business	5%	5%
2. Business tax rate applicable on service fees paid to foreign entity* in one single de minimis payment	5%	Exemption of business tax on services fees paid in one payment which is below prescribed limit to be determined by MOF.
* With no fixed place of business within Taiwan.		
** Refers to entities engaged in banking, insurance, investment trusts, securities, futures, commercial paper and pawn-broking businesses.		







# South and Southeast Asia

India

Indonesia

Singapore

# India

## Recent tax developments in Indian financial services sector



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### Background

The global financial recession which started off as a sub-prime crisis has brought all nations including India into its fold. The Gross Domestic Product (GDP) growth rate which was around 9% over the last four years has slowed since the last quarter of 2008 owing to deceleration in employment, export-import, tax-GDP ratio, reduction in capital inflows and significant outflows due to economic slowdown. Higher input costs and dampened demand have dented corporate margins while the uncertainty surrounding the crisis has affected business confidence leading to the crash of the Indian stock market and volatility in the forex market. Nevertheless, a sound and resilient banking sector, well-functioning financial markets, robust liquidity management, payment and settlement infrastructure, buoyancy of foreign exchange reserves and several measures undertaken by Indian government to address the downturn have helped the Indian economy remain largely immune from the contagious effect of the global meltdown.

The current year and the year to come are expected to be a turning point in the context of the Indian tax and regulatory changes. The key tax developments during the year are discussed below.

### Finance Act (No. 2), 2009

The Finance Act (No. 2), 2009 ("Finance Act") has introduced relatively limited changes in the taxing framework for the financial services industry but has put much more emphasis on the infrastructure sector, which is closely inter-twined with the financial services industry. This would help the financial services industry leverage off the various initiatives taken by the government vis-à-vis the benefit for the infrastructure sector.

The Finance Act could be regarded as ground breaking in terms of the tax reforms. With the rationalisation of tax rates, the government has announced / initiated several innovative measures in the tax proposals such as introduction of the draft Direct Tax Code, commitment of the Central Government in accelerating the introduction of Goods and Services Tax regime by April 2010 which would have a far-reaching positive impact on the Indian tax system, introduction of Dispute Resolution Cell and the proposed safe harbour rules, etc. The above reforms aim to address the issue of unwanted litigation in India, which has been one of the biggest concerns for both Indian and foreign taxpayers. Apart from the above, summarised below are some of the other key amendments and their impact on the industry:

#### 1. Tax scheme for Limited Liability Partnerships

The much awaited taxation scheme for Limited Liability Partnerships (LLPs) has been introduced. Based on this scheme, LLPs would have one-level taxation i.e. taxation in the hands of LLP and exemption from tax in the hands of partners.

- With a view to bridge the gap between the unlimited personal liability of traditional partnership form of business and the statute-based governance structure of the limited liability company, LLP has been proposed as an alternative form of business structure. The LLP provides the benefits of limited liability of a

company but allows its members the flexibility of organising their internal structure as a partnership based on mutually arrived agreements. However, under Indian Exchange Control Regulations, foreign investment in a partnership is not under automatic route and hence clarity is awaited on foreign investment in LLPs.

- The LLP form of vehicle would foster the growth of the services sector by providing a platform to small and medium enterprises and professional firms to conduct their business / profession efficiently. Owing to flexibility in its structure and operation, the LLP would also be a suitable vehicle investment by venture capitalists.

## 2. Introduction of Dispute Resolution Mechanism

With a view to facilitate expeditious resolution of disputes relating to Indian transfer pricing matters, an alternative dispute resolution mechanism has been introduced by the Finance Act. This would help to facilitate resolutions of transfer pricing disputes on a fast track basis and in turn help in encouraging growth of foreign investments in India.

## 3. Rationalisation of Tax rates

Fringe Benefit Tax and Commodities Transaction tax have been abolished. Further, the rate of Minimum Alternate Tax for corporates has been increased from 10% to 15% and the threshold limit for payment of Wealth Tax has been increased from INR 1,500,000 to INR 3,000,000.

## Policy Initiatives

### 1. Direct tax code

Complexity and uncertainty have been the bane of the Indian tax system since its inception. It is with a view to change the tax structure and provide simplicity and certainty in tax laws that the Government has issued the draft Direct Tax Code

(the “Code”) along with Discussion Paper which has been released for public comments. The Code is proposed to be effective from 1 April 2011 and would replace the existing Income-tax law upon enactment. The significant changes proposed therein are vis-à-vis personal and corporate taxation, though the basic structure continues to be the same. Specifically, the focus of the Code is on minimising exemptions and broadening the tax base. Some of the relevant provisions of the Code relating to financial service sectors have been summarised below:

- On the tax front, the Code proposes certain watershed provisions. For instance, from a tax treaty perspective, the discussion paper (released along with the Code) states that in case of any conflict between the treaty provisions and the provisions of the Code, the one determined at a later point in time will prevail.
- Capital gains are proposed to be taxed at a uniform rate of 30% irrespective of the period of holding of the capital asset. The concessionary tax rates on sale of equity shares / equity oriented mutual funds on a stock exchange would no longer be available. While the distinction of capital gains based on holding period is eliminated, the capital gains arising from the transfer of investment asset after one year from the end of the financial year in which the asset was acquired would be eligible for indexation benefit.
- The Code introduces General Anti-Avoidance Rules (GAAR) to discourage transactions designed for tax evasion or which lack commercial substance. Under the GAAR, sweeping discretionary powers have been given to tax authorities to disregard investment structures. The onus to prove the genuineness of purpose of the arrangement is on the taxpayer. Moreover, tax benefit cannot be the main purpose of any arrangement. The arrangements covered by the GAAR would include round trip financing, lifting of corporate veil, etc.

- From a transfer pricing perspective, the Code seeks to bring about far-reaching changes. The ambit of transfer pricing regulations has been significantly expanded by amending the various threshold limits (e.g. 10% of shareholding instead of present 26%) for considering two enterprises as 'Associated Enterprises'.
- The Code has also introduced APA mechanism and has retained the Dispute Resolution Panel. With the increased focus on dispute resolution, it is expected that the burden of uncertainty faced by non-residents in their international transactions will recede considerably in the coming years and would bring huge sigh of relief to them.
- The Code proposes to treat financial intermediaries like mutual funds, venture capital funds, pension funds, superannuation funds, provident funds and life insurance companies as pass-through entities, irrespective of the sectors in which they invest. The income is proposed to be taxed in the hands of investors.
- Under the existing provisions of the Act, the Minimum Alternate Tax (MAT) is computed with reference to book profits. However, under the Code, it has been proposed to compute MAT with reference to the value of gross assets. The rate of MAT for banking companies is proposed to be higher of 25% on total income or 0.25% of gross assets (2% for other companies including non-banking financial companies – "NBFCs"). This may impact the tax liability of several asset / capital intensive companies such as NBFCs, infrastructure companies.
- Foreign bank branches are proposed to be liable to an additional tax at 15% towards branch profits tax. Further, it has been proposed to allow head office expenses to the extent of 0.5% of turnover only.
- Under the Code, no separate tax regime has been prescribed for Foreign Institutional Investors (FIIs) and they shall be treated on par with other non-residents.
- Under the Code, even interest income on loan provided by a non-resident to another non-resident could become taxable in India, if the loan is used for any source of income in India. For example, interest paid by FIIs on offshore leverage for investment in India could become taxable in India, subject to availability of treaty benefits.
- Under the Code, it has been proposed to simplify the rules for taxation of trusts by removal of differential and complex tax regime for determinate and in-determinate trust. However, pass-through status for trust taxation is proposed to be continued.
- Under the Code, any foreign company could be considered a resident in India even if control and management is situated partly in India at any time during the financial year. This could impact fund structures having entities based at overseas level, especially entities based in non-treaty countries which could be partly managed from India.
- Income from indirect transfer of capital asset situated in India is proposed to be treated as accruing or arising in India which could possibly impact offshore funds/companies contemplating exits at the offshore level.

The Finance Minister has issued a press release stating that the initial reaction on the draft of the Code has been very encouraging. On the basis of interactions with the stakeholders, the Government has identified nine critical areas for further detailed examination; it inter alia comprises the concept of MAT based on value of gross assets; Capital Gains Taxation in the case of non-residents; the overriding provisions of the Income Tax Act vis-à-vis DTA; GAAR; issues relating to effective management, control and taxation of foreign companies in India; etc. The Code has been proposed to be presented before the Parliament during the upcoming winter session, 2009.

## 2. Goods and Services Tax

- Based on the proposed Goods and Service Tax (GST) regime, India proposes to implement a dual GST whereby a Central Goods and Services Tax (CGST) and State Goods and Services Tax (SGST) will be levied on the taxable value of a transaction of supply of goods and services. Both the Centre and the State will legislate, levy and administer the CGST and the SGST respectively.
- The proposed dual GST model will subsume taxes like central excise, service tax, VAT, central sales tax, entertainment tax, luxury tax, octroi, electricity duty and purchase tax. Taxes like stamp duty, toll tax, passenger tax and other road tax will not be subsumed. While all goods and services are to be taxed with few exceptions, goods will be classified based on the Harmonised System of Nomenclature classification and services will be classified based on the global best practices and Indian realities. Services will likely be taxed at the uniform rates while multiple rates could exist for taxing goods.
- Further, uniform thresholds and exemptions will be applicable for Central and State GST with little flexibility for the States to deviate. Existing exemption schemes are proposed to be converted into post tax cash refund schemes. Full input credit of the Central GST and State GST will operate parallel under this model and cross utilisation of credits between Central GST and State GST will not be allowed. However, the unutilised accumulated input tax credits will be available for refund at the end of each fiscal year. There would be no tax in the originating State on inter-state supplies as the GST will be destination based. Also, exports will be zero-rated.
- Amendments to the Constitution are essential so as to enable the Central Government to tax beyond the manufacturing stage and for the State Governments to be able to charge service

tax. Federal GST is required to be drafted along with uniform State GST law. Integration is required among large number of Central and State taxes, consensus needs to be obtained amongst State to abolish multiple local taxes, and thresholds needs to be rationalised across excise, service tax and VAT.

## Other Tax Developments

### 1. Certain Key Judicial precedents

- Offshore Exits under scrutiny

In the recent Hutch-Vodafone case, Vodafone (incorporated in the Netherlands) acquired shares (controlling stake) of a Cayman company (by way of a transfer) from Hutchison (which held shareholding in an Indian company through its subsidiaries). The Indian tax office contended that the overseas transfer of shares of the Cayman company resulted in transfer of shareholding interest of the said Indian company and hence, taxable in India. Based on the Indian tax office, Vodafone was under an obligation to withhold taxes on consideration paid to Hutchison. Vodafone filed a writ petition in the High Court challenging the tax office's jurisdiction to issue the notice which was dismissed by the High Court observing a prima facie taxability of the transaction in India. Against the judgment of the High Court, Vodafone filed a special leave petition before the Supreme Court to seek an interim relief against the said order. However, the Supreme Court rejected the petition and the matter was referred back to the tax office with a specific direction to decide on the jurisdictional issue.

Based on certain news reports, it is understood that the Indian tax authorities have aggressively applied this decision on various transactions executed outside India thereby bringing a significant number of offshore private equity, merger and acquisition deals under scrutiny.

- **Adequate Substance of Overseas entity**

In the case of E-Trade, the tax office has denied the treaty exemption in respect of sale of Indian company's shares by a Mauritius company which was holding a valid tax residency certificate. In the said case, E-Trade Mauritius (incorporated in Mauritius), an indirect wholly owned subsidiary of E-Trade US, sold shares of an Indian company to another Mauritius company, HSBC. E-Trade Mauritius applied for a nil tax withholding order to the Indian tax office seeking the benefits under the India-Mauritius tax treaty which was rejected by the Indian tax officer with a direction to HSBC to deposit the taxes withheld. E-Trade Mauritius filed a writ petition with the Bombay High Court which instructed E-Trade Mauritius to file a revision petition with the Director of Income Tax (International Taxation) and directed HSBC to deposit the taxes withheld with the High Court. However, the Director of Income Tax confirmed the order of the assessing officer and held that the gains accrued to E-Trade US and hence E-Trade Mauritius is not eligible for treaty benefits under the India-Mauritius tax treaty and that taxes need to be withheld from the payment of consideration by HSBC. The High Court took the order into account and directed that the amount deposited with it be released to the tax office towards the tax liability determined and the balance be refunded to E-Trade Mauritius.

While this case is not a Court ruling that has a bearing on the legal position, it does go against the position laid down by the Supreme Court in the landmark case of Azadi Bachao Andolan (which stated that a Mauritius tax residency certificate (TRC) was sufficient for a Mauritius entity to claim treaty benefits) and has led to several similar challenges from the tax office as to the substance at the Mauritius holding company level.

In another ruling in case of Saraswati Holdings, the Delhi bench of Tribunal i.e. the second appellate authority had the occasion to decide upon the eligibility of an assessee to claim benefits under

the India-Mauritius DTA on the basis of a valid TRC produced before the Indian tax authorities. The Delhi Tribunal has upheld the principles laid down by the Supreme Court in the case of Azadi Bachao Andolan thereby holding that a valid TRC issued to a resident of Mauritius entitles is for the purposes of claiming the benefits under the India-Mauritius tax treaty. It is interesting to note that the Tribunal disregarded the argument put forth by the tax authorities that the Mauritius company (in the present case) was effectively 'controlled and managed from outside Mauritius', and thereby rejecting the claim by the tax authorities that the Mauritius company was not entitled to treaty benefits.

- **Head office expenses of non-resident**

In case of Bank of America NT and SA, the assessee, Bank of America NT, is a non-resident foreign banking company with branches in India. It had claimed expenses incurred by overseas branches in respect of an India desk maintained by those branches. The tax officer invoked the provisions of section 44C of the Act in respect of these expenses as relevant documents were not produced confirming that the expenditure was exclusively related to the business of the Indian branches of the assessee. The first appellate authority upheld the action of the tax officer, considering the expenses as general head office expenses on the grounds that the NRI's desks must be guiding customers not only of Indian origin but from other Asian countries as well. On further appeal to the Tribunal, it was observed that the counsel for the revenue authorities did not have any evidence to support the argument that the expenses were incurred for other Asian countries' Desks. It was held that the limitation prescribed under section 44C would not apply in respect of expenses which are exclusively incurred for the purpose of the Indian operations of the assessee. The Tribunal also held that the claim could be allowed even if corresponding entries were not made in the books of the Indian branch.

- **Mutual Fund launch and promotion expenses**

In case of First India Asset Management (P) Ltd, the assessee, an asset management company (AMC), is the fund manager of mutual fund schemes. The assessee had incurred expenses for launching and promoting a mutual fund which was disallowed by the tax officer on the grounds that the assessee had received advisory fees for managing the funds of the mutual fund that it was not required to incur for launching and promoting the mutual fund. The disallowance was confirmed by the first appellate authority as the assessee had no statutory or contractual obligation to incur the said expenses. On appeal before the second appellate authority i.e. Tribunal, the assessee's counsel submitted that the expenses were incurred by the assessee to meet the objects as stipulated in the tripartite agreement and were in accordance with the SEBI (Mutual Fund) Regulations. The SEBI Regulations sets a limit on initial issue expenses which can be borne by the MF. Any expenses incurred beyond this limit had to be borne by the AMC. This limit was incorporated in the tripartite agreement, and thus, the assessee was under a contractual obligation to incur these expenses. The expenses were incurred by the assessee wholly and exclusively for the purposes of its business. The expression "wholly and exclusively" used in section 37(1) of the Act does not mean "necessarily", Even expenditure incurred "voluntarily" without any "necessity" would be permissible for deduction under section 37(1) of the Act if it was incurred for promoting the assessee's business. Thus, the assessee's claim was upheld by Tribunal.

## 2. Other Updates

- Updates on tax treaties

During the past one year, tax treaties with Myanmar, Tajikistan, Luxembourg, Montenegro and Serbia have been notified.

Noteworthy amongst the above tax treaties is the India-Luxembourg Tax Treaty, the key features of which are as follows:

- Concessionary withholding tax rate of 10% shall be applicable to interest payment subject to a condition that the recipient is beneficial owner of interest income
- Capital gains from alienation of shares shall be taxable in the source country though gains from alienation of debentures shall be exempt in source country
- 'Limitation of Benefits' clause present to prevent misuse of treaty provisions

The Government has revised the existing tax treaty between India and Syrian Arab Republic thereby incorporating improvements over the existing tax treaty inter alia by including anti-abuse provisions for the source-based taxation of capital gains from the alienation of shares.

- Withdrawal of beneficial circulars dealing with taxability of non-residents

The Indian tax authorities had issued a Circular No. 23 dated 23 July 1969 which provided certain clarifications in respect of income accruing or arising through or from any business connection in India. Thereafter, the tax authorities had issued certain further clarifications vide two more circulars. However, recently, the tax authorities have withdrawn the above circulars with immediate effect. The tax authorities have reasoned that the interpretation of the above circulars by some of the taxpayers was to claim relief, which was not in accordance with the provisions of the Indian tax laws or the intention behind the issuance of said circulars.

# Indonesia

## Tax developments in Indonesia



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### **Tough new rules for claiming tax treaty relief for Indonesian withholding tax**

There are continuing signs that the Directorate General of Taxation (DGT) is aggressively tackling perceived tax avoidance arrangements. On 5 November 2009, two regulations were released (DGT Regulations 61 and 62), setting out new procedures which must be followed for reduced rates of withholding tax to apply to payments made to non-Indonesian residents who are residents of countries with which Indonesia has concluded tax treaties.

To claim tax treaty relief, the non-resident recipient of the income must obtain a Certificate of Domicile (COD) from the tax authority in its home country, and establish that it is the beneficial owner of the income. The new rules under Regulations 61 and 62 make it significantly harder for non-residents to meet these requirements.

To obtain treaty relief, the DGT regulations now require an entity or individual that is the owner of the income to demonstrate that it is not considered to be misusing the tax treaty, by satisfying these tests:

- For individuals, that they are not receiving income as an agent or nominee;
- An institution that is explicitly named in the tax treaty or one that has been agreed to by the Competent Authority in Indonesia and its treaty country partner;
- An offshore company (WPLN) which earns income through a custodian from share or bond transactions made on the Indonesian Stock Exchange (except interest and dividends), that is not an agent or nominee;
- A company whose shares are listed on the Stock Exchange and traded regularly;
- A bank; or
- Any other company which meets the following requirements:
  - the establishment of the company in the tax treaty partner country and the way the transaction is structured/schemed, is not merely done to enjoy tax treaty benefits;
  - the business activities are managed by the company's own management which has sufficient authority to carry out the transaction;
  - the company has employee(s);
  - the company has activities or active business,
  - income derived from Indonesia is taxable in the recipient's country;
  - the company does not use more than 50% of its total income to fulfill its obligations to other parties, such as interest, royalty, or other payments.

Types of income payments which are subject to reduced or zero withholding tax rates under Indonesia's tax treaties are:

- Interest
- Dividends
- Royalties
- Service Fees
- Capital gains taxes and branch profits tax

Therefore, the new rules potentially apply to a broad range of taxpayers.

The other significant change under the new regulations is that a COD must be obtained by the non-resident each time it receives income of a type that is subject to Indonesian withholding tax. The COD must be provided to the payer by the time it lodges its monthly tax return for the period in which the income is paid, i.e. the 20th of the following month.

The only exception to this requirement is where the recipient of the income either:

- is a non-resident bank; or
- derives capital gains from sales of shares and bonds listed on the Indonesian stock exchange and held through a custodian.

In these cases, the COD obtained by the recipient remains valid for twelve months.

Another important feature of the new regulation is that the COD must be in a form approved by the DGT. It is not yet certain how tax authorities in other countries will respond to requests for CODs in the form prescribed by the DGT.

The new COD requirements will be difficult for taxpayers to comply with in practice, especially the requirement that they be obtained monthly. To obtain a COD, a number of specific questions must be answered, based on which the DGT will determine whether or not the income recipient satisfies the beneficial ownership requirement.

On a more positive note for taxpayers, we believe the release of the new regulations removes the previous obstacle to the ratification of the new Netherlands tax treaty. Under that treaty, a zero withholding tax rate applies to interest paid to a Dutch resident.

Another positive development relates to share transactions on the Indonesian stock exchange, which currently attract tax at a rate of 0.1% of the transaction value.

The new form of COD implies that where gains are made by a non-resident with a COD from one of Indonesia's tax treaty partners, they can enjoy capital gains tax relief for shares and bonds listed on the Indonesian stock exchange.

In another concession, the DGT acknowledges that where a non-resident taxpayer is unable to satisfy the COD requirements when it receives income, so that a higher non-treaty withholding tax rate applies, the non-resident will be able to claim a refund of the overpaid tax if it is able to meet the COD requirements at a later date. Unfortunately, the procedure for obtaining such refunds has not yet been explained.

There are numerous technical issues arising from the new regulations, where the application of the regulations remains uncertain. Further clarification is required from the DGT, including potential errors with some of the requirements spelt out in the new COD as regards eligibility for treaty relief.

To summarise, for most taxpayers the new regulations will impose more onerous requirements which will be difficult to comply with in practice. For Indonesian taxpayers making payments subject to withholding tax to non-resident recipients, special care will need to be taken and new procedures put in place before they may apply the lower withholding tax rates on the basis of treaty relief. Under the DGT's compliance approach, in the event of a future audit, any failure to obtain the correct COD documentation and compliance

with other administrative requirements will result in the payer being exposed to payment of the withholding tax shortfall and associated penalties.

From 1 January 2010, it will be very difficult in practice for Indonesian payers of income to non-Indonesian recipients to obtain treaty relief from any withholding tax that is due. Payers will need to satisfy themselves that recipients can meet all requirements under the new regulations before treaty relief applies.

## 2009 Corporate Income Tax Return

The 2009 financial book year will soon end and annual corporate tax return season will return with the deadline to submit 2009 Corporate Income Tax Return (CITR) by 30 April 2010.

In relation to the preparation of 2009 CITR, the tax office issued new regulation regarding the changes of the CITR form (form 1771), which requires the

disclosure of related party transactions and transactions with tax haven country.

Under this new form, there are various information and documentation requirements taxpayers must observe, including:

- Organisation structure of the company;
- The transfer pricing policy of the company;
- The methods used in pricing related party transactions;
- Functional analysis of the company;
- The availability of transfer pricing documentation;
- Transaction with tax haven country.

Taxpayers should start preparing for these changes early, given that they will need time to collate this information as well as to put in place the relevant documentation.

# Singapore

## A new Singapore tax case to keep a lookout for – withholding tax treatment of interest rate swap payments



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### Background

The Inland Revenue Authority of Singapore (IRAS) issued a practice note in 1998, indicating its position on whether payments made on interest rate or currency swaps to non-residents are subject to withholding tax. Contrary to common industry understanding of such instruments, the IRAS came to the conclusion that all payments on interest rate or currency swaps constituted “payments in connection with any loan or indebtedness” under section 12(6)(a) of the Income Tax Act and were subject to withholding tax when made to non-residents.

This practice note has created uncertainties for financial institutions in Singapore dealing in derivatives with offshore counterparties. This issue has been alleviated to a certain extent with the introduction of various exemptions, the latest being the withholding tax exemption on payments made by financial institutions on over-the-counter financial derivatives. This withholding tax exemption, however, has an expiry date. Furthermore, it remains an issue for Singapore-based counterparties that are not financial institutions, who may then have to bear the withholding tax on such payments.

Something that might bring some excitement to taxpayers in this regard is a recent judgment issued

by the Singapore High Court, which came to the preliminary view that payments on interest rate swaps (IRS) are not payments made in connection with any loan or indebtedness.

### Overview of the case

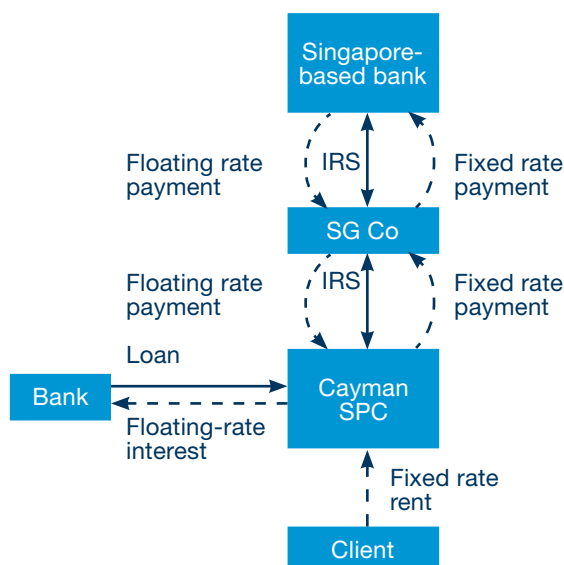
In the case of *ACC v CIT* [2009] SGHC 211, a Singapore-incorporated company (“SG Co”) applied for leave to quash the decision of the Comptroller of Income Tax (the “Comptroller”) that withholding tax is applicable on IRS payments made to its non-resident subsidiaries.

Briefly, the facts of the case are as follows:

- SG Co and its overseas subsidiaries were in the business of leasing certain machinery. Most of the subsidiaries were special purpose companies (SPCs) incorporated in the Cayman Islands.
- Each SPC owned only one machine, and each SPC entered into a loan agreement with offshore banks to finance the purchase of its machine.
- In the event that the lease entered into by a SPC was at a fixed-rate rent, the SPC would be exposed to interest rate fluctuations if its financing were at a floating rate. To hedge the interest rate risk exposure in this case, the SPC would enter into an IRS whereby:
  - the SPC would pay the counterparty fixed rate payments computed as a fixed percentage of a notional amount; and
  - in exchange, the counterparty would pay to the SPC on the same dates the floating rate percentages of the same notional amount.
- To reduce the administrative burden and to dispense with guarantees that SG Co would have to be put up if each SPC were to enter into the IRS separately, SG Co put in place an arrangement whereby it would enter into IRS with Singapore banks or Singapore branches of foreign banks. SG Co will then enter into IRS agreements that mirror these agreements with each SPC.

- The net IRS payments and receipts were recorded in SG Co's balance sheet as "amount owing to/by subsidiary", as the IRS were intended for the SPCs. No tax deduction was claimed by SG Co on IRS payments to the SPCs, and the receipts from the banks on the IRS were not brought to tax.
- SG Co sought confirmation from the Comptroller that withholding tax was not applicable to the IRS payments made by it to the SPCs. The Comptroller responded negatively to the request.
- SG Co then applied to the High Court for leave to apply to quash the determination by the Comptroller.

In deliberating whether to grant leave to SG Co to seek a quashing order, Andrew Ang J had to consider, amongst other things, whether the material put forth disclosed an arguable case or prima facie case of reasonable suspicion in favour of granting the public law remedies sought by the applicant (i.e. SG Co in this case). He came to the preliminary view that the IRS "payments are not made in connection with any loan or indebtedness but for the purpose of hedging risks" on the following basis:



- Neither party to the IRS transaction made any loan to the other so as to give rise to an obligation on the part of the other to pay interest. Thus, IRS payments neither constituted interest nor any other payment in connection with any loan or indebtedness. This is despite the fact that the quantum of the periodic payments to be made by each party was computed in the same way that interest was calculated but in respect of a notional amount.
- It is merely a contractual swapping of cash flows.

He was also of the view that the payments do not appear to be connected with any "arrangement, management, guarantee or service relating to any loan or indebtedness". In view of the above, he granted SG Co leave to seek a quashing order. Andrew Ang J acknowledged that this preliminary analysis of application of section 12(6)(a) to IRS payments should not be taken as a substitute for a determination at the full hearing of the application for a quashing order.

The judge did not go on to analyse SG Co's argument that the IRS payments should nonetheless fall outside section 12(6)(a) on the basis that they were neither borne by SG Co nor deducted against its Singapore-sourced income, which would be left for consideration at the full hearing.

## What are the implications?

In arriving at his decision, the judge made the point that IRS "payments are not made in connection with any loan or indebtedness but for the purpose of hedging risks". Does this then mean that an IRS entered into for trading purposes would have to be distinguished from one entered into for hedging purposes for application of withholding tax? As pointed out by Andrew Ang J, the crux of the issue is whether the IRS results in any loan or indebtedness between the two parties to the transaction. And since an IRS transaction typically does not create any indebtedness between the parties to it, section 12(6), and consequently the withholding tax provisions, should not apply.

In this case, the judge did not deliberate the questions of whether the words “in connection with” could have a broader meaning, or whether IRS payments could be considered “payments ... in connection with any arrangement ... relating to any loan or indebtedness” under section 12(6)(a). Consider the scenario in which a Singapore company obtained a floating-rate loan from a bank in Singapore. To hedge its interest rate exposure, the Singapore company then enters into an IRS with a bank outside Singapore, under which it made IRS payments at a fixed-rate to the offshore bank. Can the fixed-rate IRS payment to the offshore bank be considered to be a “payment in connection with” the loan taken up by the Singapore company from the Singapore-based bank, since the IRS payment was made to hedge exposure on the loan? If not, can the IRS payment be considered “a payment in connection with any arrangement relating to any loan or indebtedness”, being a payment in connection with an arrangement set up to hedge interest rate exposure on a loan? Hopefully more light will be shed on these points at the substantive hearing.

Putting aside the choice of prepositions for section 12(6)(a) and looking back at the mechanics of IRS, one question that the IRAS may be concerned with

is whether IRS transactions truly never result in an element of loan or indebtedness between the parties to the transaction. Usually, this would be the case. However, it is possible to structure a swap such that there is a substantial lag in the timing of exchanges of cash flow. For example, a swap agreement can be set up whereby the non-resident party makes an upfront payment to the resident party, and the resident makes a series of payments over a period of several years to the non-resident. The periodic swap payments would presumably be computed such that they include an element of interest. Although taking the form of a swap, the transaction may be in substance a loan by the non-resident party to the resident party. In such a scenario, the transaction should fall within the scope of section 12(6) and withholding tax may apply, although the position is not entirely clear. This is unlike the case of *ACC v CIT*, where there is no lag in the timing of the exchange of cash flows, which is the case in most typical IRS transactions.

It will be interesting to see how the analysis will finally pan out in the full hearing for the quashing order application. Depending on the aspects that will be considered, the outcome of the full hearing may also have an impact on the withholding tax treatment of payments on derivatives other than IRS.



# Australasia

Australia



# Australia

## Developments in Australia



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The major banks in Australia have recently reported their 2009 earnings to the market. Their results show that the financial environment in Australia has generally outperformed expectations.

With this backdrop, it's of no surprise that there are a number of tax and other developments of relevance to Australia's banking and capital markets (BCM) and financial services sectors.

### **Taxation of financial arrangements**

A new regime for the taxation of financial arrangements, known as "TOFA", has been enacted in Australia and will apply for income years commencing on or after 1 July

2010. However, a taxpayer can elect to apply the new rules one year early, i.e. from 1 July 2009.

The key features of TOFA are:

- The new rules apply to "financial arrangements" as defined.
- The new rules apply to "new" financial arrangements only, those which arise after the commencement of TOFA, unless a taxpayer makes an election to transition existing financial arrangements into TOFA. If such an election is made transitional balancing adjustments typically arise.
- Gains from financial arrangements are assessable and losses from financial arrangements are deductible; there is no longer any capital versus revenue distinction for financial arrangements. The tax hedging regime is an exception to this.
- There are default timing rules that determine when a gain is assessable and when a loss is deductible. In general, gains and losses that are certain are accrued, and gains and losses that are uncertain are brought to account on a realisation basis.
- There are elective tax timing methods to enable the tax outcomes from financial arrangements to be aligned with accounting outcomes, including a fair value, a foreign currency retranslation and a financial reports methodology.
- There is an elective tax hedging regime which allows the tax outcomes on hedging instruments to be aligned in terms of timing and character with the outcomes of the underlying item being hedged.

TOFA has a major impact on the financial services sector. This is because financial services entities are in the business of providing or investing in financial arrangements.

Within the BCM sector, consideration is being given to whether the new rules should be applied one year early, what is the transitional impact and what are the costs and benefits of aligning tax outcomes with accounting outcomes. The size and scope of the TOFA implementation project for banks is significant. It affects banking business in many different ways,

including systems requirements, risk and compliance, regulatory outcomes, hedging strategy and product innovation.

Within the funds management sector, the impact is less due to a general reluctance to align tax outcomes with accounting outcomes because of fair value volatility. But there are major systems changes required to accommodate a shift into an accruals and realisation framework and to transition existing financial arrangements. The impact arises for software providers, custodians and fund managers.

## Compliance and risk reviews

The Australian Taxation Office (ATO) released its Compliance Program for 2009-10 in August 2009. The ATO's stated goal in publishing its Compliance Program is to alert taxpayers to its identified risk areas and the strategies it plans to implement to deal with those risks. The Program also sets out a range of measures to help people who are trying to comply with their tax obligations and, in particular, this year has been developed in the context of the global economic downturn, which the ATO advises has already had an adverse effect on revenue collections.

The ATO continues to more broadly examine transactions between related Australian and offshore entities, undertaking reviews and audits in "high risk" cases. Particular attention is being paid to taxpayers with a history of profitability falling consistently below industry averages and the use of arrangements between related Australian and offshore entities to shift profits (and tax) from Australia to other countries, including restructuring of Australian-based operations seeking to shift functions, assets and risks offshore on a non-arm's length basis, the allocation of excessive interest, guarantee and other fees, and the allocation of income and expenses to Australian entities and permanent establishments which are inconsistent with the economic activities conducted in Australia.

Within this compliance framework, the ATO is focusing industry wide attention on a number of cross-border financial arrangements and transfer pricing.

- **Derivatives that transfer losses (including credit losses) to Australia**

In November 2008, the ATO issued a Taxpayer Alert indicating that it was focusing on any arrangements that might have the purpose of shifting losses from foreign operations to Australia. This could include, for example the transfer of unrealised loss assets or distressed debts into Australia.

- **Cross-border financing arrangements that shift interest deductions into Australia**

In April 2009, the ATO issued a Taxpayer Alert setting out its view that Australia's anti-avoidance provisions may apply to certain financing arrangements that generate interest deductions where funds are used to earn foreign dividend income which is not subject to Australian tax.

- **Asymmetric swap arrangements involving an Australian entity**

In October 2009, the ATO issued a draft Taxation Determination setting out its view that Australia's anti-avoidance provisions may apply to asymmetric swap arrangements. An asymmetric swap arrangement involves two swaps that may result in income being taxed at a low tax rate (for example, under Australia's Offshore Banking Unit regime) and losses being deductible at a high tax rate (for example, under Australia's general domestic provisions).

- **Thin capitalisation calculations**

As part of its risk review processes, the ATO has identified taxpayers likely to be in serious risk of failing the safe harbour test if they have not taken appropriate action. The ATO will particularly target the correctness of the application of the safe harbour test and is undertaking a thin capitalisation project which includes following up on non-lodgment and incorrect completion of thin capitalisation schedules.

Additionally, the ATO has recently announced that it is changing the information that large financial services taxpayers must provide annually to the ATO with its tax returns. These changes are aimed at enhancing the information and data on which the ATO can assess tax risks within the financial services industry. Under these data collection changes, financial services entities with gross turnover of A\$250 million or more must provide comprehensive information to the ATO, including in relation to international dealings, transfer pricing, foreign income and foreign investments.

## Tax and industry reform

The Australian Government has long had a goal of developing Australia as a regional financial services hub.

Recently, the Financial Development Report 2009 issued by the World Economic Forum (WEF) ranked Australia second among the world's financial centres, ahead of the US, Singapore and Hong Kong.

In the WEF's Financial Development Index, Australia ranked 1st in terms of financial access and performed very well in both banking (5th) and non-banking (3rd) financial services.

There are a number of tax and industry reform initiatives that have been undertaken, aimed at improving or enhancing Australia's financial services capabilities. These include:

- Withholding tax on certain foreign distributions from managed investment trusts has been cut from 30% to a final rate of 7.5%.
- The Australian Financial Centre Forum has been established, which later this year will report on further ways to improve the competitiveness of Australia's financial system and the clarity of taxation rules.
- Australia's attribution rules in respect of offshore investments will be modernised and simplified to reduce compliance costs.

- Supervision of Australia's financial markets will be transferred from the Australian Securities Exchange to the Australian Securities and Investment Commission, the corporate regulator.

In addition to this, there are two significant tax reform projects still being undertaken that impact the financial services sector.

## The Henry Review

In August 2008, the Government announced that it was embarking on a major review of Australia's tax system, which has become known as "the Henry review". The Henry review has been catalyst for significant public commentary on the Australian tax system and the outcomes of the review could have a significant impact on Australia's financial services sector.

The Henry review is due to deliver its findings to Government in December 2009 and the Government's response is due in March 2010.

In the financial services sector, two of the most significant areas of focus could lead to:

- A reduced company tax rate.
- A review of how investment income is taxed in Australia, including the introduction of progressive tax scales for the taxation of interest income.

If there is a reduction in the company income tax rate, this could have a significant favorable impact on the after tax returns of business activities conducted in Australia.

If there is a reduction of the current personal tax rate on interest income, this could increase the flow of retail deposits into Australian banks and deposit-taking institutions and lead to some innovation in retail banking products.

## Review of Managed Investment Trusts

In February 2008, the Government announced that it had asked the Board of Taxation in Australia to undertake a review of the tax arrangements applying to managed funds that operate as managed investment trusts (MITs).

The objective of the review is to provide advice on options for introducing a specific tax regime for MITs which would reduce complexity, increase certainty and minimise compliance costs.

On 12 May 2009, the Government announced that it would implement the Board of Taxation's interim advice on the taxation of managed funds to provide deemed capital account treatment for gains and losses made on disposal of investment assets by MITs, subject to appropriate integrity rules.

The Board has now completed its review of the taxation arrangements applying to MITs and provided its report to the Government. In preparing its report, the Board took into account the various submissions to the review and discussions with stakeholders. In line with past practice, the Board's report is expected to be available at the time the Government releases its response to the report.

The Government is expected to provide a response to the Board's recommendations in 2010.

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