www.pwc.com

BCM Tax

A commentary on Banking and Capital Markets tax issues in Asia Pacific

BCM Tax, a publication by PwC's Asia Banking and Capital Markets Tax Network covering the hot topics in international taxation and their impact in Asia Pacific.

November 2011

pwc

Contents

Foreword

While tax was not the cause of the global financial crisis, it has been said in some quarters that it contributed to it. Among other things, the availability of deductions for interest expenses but not for returns on capital (e.g. dividends) is often seen as encouraging enterprises to increase gearing ratios. This, in turn, helped fuel the rapid increase of debt levels prior to the crisis while at the same time reducing, in relative terms, the buffer provided by capital; when the credit crisis arrived, these enterprises found that their levels of debt were unsustainable and there was insufficient capital to continue to finance the business.

In the eyes of much of the public, the banking sector is seen as the primary beneficiary of the pre-crisis boom in debt levels, but at the same time was the beneficiary of large amounts of public aid once the crisis arrived. It is a response to this perception that has led, since the crisis, to a proliferation of taxes, both proposed and introduced, on the financial sector, including financial activities taxes, bank levies, financial transactions taxes, etc. These measures seek to address the perception that the financial sector is under-taxed, or at least not bearing its fair share of taxes, not only because of the public aid it received, but also because it enjoys exemption from goods and services tax (GST) / value-added tax (VAT).

In the lead article of this issue, we examine the impact of indirect taxation as it relates to the banking sector, and explore if the exemption regime in GST/VAT systems indeed confers a tax advantage on banks over the non-bank taxpayers. We will also consider how some countries in Asia Pacific alleviate the cost of what would otherwise be irrecoverable input tax through various mechanisms.

The diversity of the Asia Pacific tax landscape continues to be reflected in the country articles from across the region. Nonetheless, a central theme that runs through these recent developments is that growth remains the focus of this region, as governments fine-tune their tax policies to promote selected areas, for example, real estate investment trusts (the Philippines), Islamic finance (Indonesia) and more generally the opportunities for tax reform (Australia) and the expansion of treaty network (Hong Kong and Taiwan).

In somewhat of a contrast to the regional scene, the jury is still out on what needs to be done to rehabilitate the economies of some of the Western countries. But whatever measures are ultimately taken, and regardless whether tax contributed to the crisis, reform of the taxation of the financial sector would appear certain to be part of the story.

November 2011

Peter Yu
Asia Financial Services Tax Leader

Paul Lau
Co-editor
BCM Tax

David Smith
Co-editor
BCM Tax

Lead Article

VAT/GST exemption: What it means for Financial Services

So while VAT or GST exemption means that banking or financial services are not subject to tax, the financial institution cannot recover the VAT or GST on costs that it incurs.

The concept of an exemption is normally welcome in the world of taxation. However, this is not necessarily the case where the exemption applies in the context of value-added tax (VAT) or goods and services tax (GST)[1]. While exemption means that the transaction is not liable to VAT or GST, it also means that in principle, the input VAT/GST on costs that are attributable to the making of the exempt transaction is not available as a credit to offset the output VAT/GST that applies on the supply that is made by the business. Paradoxically, it is better to be taxable from a VAT/GST perspective as it means being able to recover the input VAT/GST.

In the Asia Pacific region where the VAT/GST systems vary as much as the economies, the common approach is to exempt financial services (including life insurance) from VAT or GST although the scope of what constitutes exempt financial services may vary among jurisdictions. The reason for the exemption is due to the wide acknowledgment that financial services can be complex and is a difficult area to tax. Given that the VAT and GST is a tax on final consumption of goods and services, the issue is in determining the "value add' in a financial transaction, and hence the value on which the VAT/GST should apply.

So while VAT or GST exemption means that banking or financial services are not subject to tax, the financial institution cannot recover the VAT or GST on costs that it incurs. Even where a reduced rate applies to certain financial services in a country like Taiwan, there are complex rules regarding the recovery of the input VAT/GST.

On the other hand, China proves to be an exception as it subjects financial services to business tax which is not creditable. However, this may change as the country looks at reforming its indirect tax system to one that resembles a classic VAT or GST system. Even then, moving from business tax to exemption for financial services may give rise to the perception that it gives a tax advantage to the banks if financial services are seen to be not liable to indirect taxes. But how much of that is true?

Does exemption give banks a tax advantage?

A study into the impact of VAT exemption on European banks was recently commissioned by 20 banks with the research undertaken by Professor Ben Lockwood of the University of Warwick and PricewaterhouseCoopers (PwC). Under the VAT exemption system for financial services in the European Union (EU), the report found that the exemption that applies to European banks did not lead to a tax advantage for the banking sector. The report concluded that if banking services were subject to VAT (instead of being exempt), it would not lead to any significant increase in EU VAT revenues. The research also found that the denial of input VAT on the banking costs led to irrecoverable VAT of an estimated amount of up to Euro33 billion per annum.

Interestingly, while similar research has not been done in Asia Pacific, it is conceivable that any such research could lead to the same conclusion as the EU study. What may be more interesting to consider is whether lowering the costs of the banking sector can lead to other fiscal advantages such as increased profitability for the financial institution.

[1] The VAT and GST operates in the same manner, being a tax on sales or supplies (output tax) with credit given for tax on business purchases or expenditure (input tax).

In a study undertaken by PwC for the European Commission to study the economic effects of the exempt treatment of VAT[2], it was commented that "…in aggregate, firms in the financial services firms in the EU25 are somewhat less profitable than their equivalents in certain other highly developed economic regions, including the United States. It cannot be stated definitively that embedded VAT costs are the cause of profitability differentials, although it is clear that the VAT exemption of financial services (and the inability to reclaim VAT on costs as a consequence) is making at least some contribution."

Looking at the Asia Pacific and in Singapore in particular, the treatment is to exempt financial services from GST in Singapore. However, to lower the costs of the input GST, Singapore has a special input GST regime that enables the bank to recover the GST on its inputs based on rates that vary between 76% to 96%. While the high input tax recovery rates mean that the financial services sector only contributes 2.6% to net GST revenue in Singapore[3], the approach is intended to provide certainty and encourage an attractive business environment for the financial institutions. The consequence of this is that Singapore has a strong financial services sector that contributed to 27.5% of the income tax collections by the Inland Revenue Authority of Singapore (IRAS) for the year ended 31 March 2011.

Exempting financial services gives rise to certain issues which are explained below.

Issues with exemption

Tax cascade

Given that VAT or GST is designed as a tax on final consumption, the VAT/GST exemption for a financial institution treats the bank as if it is a final consumer by imposing the irrecoverable tax on the bank itself.

The issue then is that if the financial institution is denied input VAT/GST deduction on its costs, it is likely that the subsequent supply of financial services by the financial institution will have the tax embedded as part of the cost base of making the supply which results in a tax "cascade". To recover the VAT/GST, the financial institution may have to charge higher fees for its services or adjust the interest margin for the financial product or service that it makes.

Barriers to outsourcing

It is a general accepted principle that a tax should be neutral and not be a factor in the business decision making process. Yet, the exemption for financial services creates a bias against the outsourcing of services that can be handled more efficiently by a third party service provider than the financial institution itself. For example, the successful outsourcing of back office and information technology activities can help a bank achieve significant cost savings from the economies of scale and streamlining of business processes. However, if the bank is denied VAT/GST deduction for the outsourcing costs, it may choose to provide the services internally by employing its own labour resources, the costs of which do not attract VAT or GST. However, this may result in a poor use of resources and operational inefficiencies if the third party services provider can supply the services more efficiently and at a lower overall cost.

[2] PricewaterhouseCoopers Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Studies – Final Report to the European Commission 2 November 2006.
[3] Annual Report 2011 Inland Revenue Authority of Singapore (IRAS).

The other issue is that the above assumes that the financial institution has a sufficiently large enough operation to be able to decide between providing the services in-house or to outsource the services. A smaller financial services provider may not have the same scale of operation and resources to handle the services internally and it has to outsource the function. This will not be a desirable situation if the VAT or GST is allowed to impact on the financial services business depending on its size of operation.

Complexity of attribution or allocation of costs

The exemption of financial services give rise to complexity and administrative cost for both the financial institution and the tax authorities, as the financial institution competes to attribute or allocate its inputs to taxable (having creditable input tax) activities to maximise its recovery of input VAT/GST against the tax authorities' goal of maximising tax revenue. Much time can be spent by the financial institution to build systems and processes to identify and track the costs and having to defend the position against the tax authorities' challenge.

There is also the complexity of defining what constitutes exempt financial services and what are taxable services which in the United Kingdom is solved to some extent by the VAT Blue Book which covers the VAT treatment of financial goods and services as agreed between the British Bankers' Association and HM Customs and Excise. There is similar guidance in Singapore with the GST Handbook for Banks published by the Association of Banks of Singapore that has been produced on consultation with the IRAS. However, given the innovative and rapid growth of financial services and products, the need to update such guidance on a regular basis can be a massive task in itself.

To address some of the above undesired consequences of VAT or GST exemption, particularly the costs of irrecoverable input credit for the financial institution, we now look at how some governments deal with the issue in the region.

Lowering the cost of exemption – allowing input taxes

Australia

Given that the financial institution is unable to recover the GST on inputs, Australia has a unique way of describing the GST exempt financial services as "input taxed" supplies. However, the definition of financial services in Australia excludes the arranging of financial services which is treated as taxable which means that the financial institution pays GST if it purchases or acquires arranger services.

To reduce the GST costs for the financial institution and to overcome the barrier to outsourcing highlighted earlier, the Australian government introduced a Reduced Input Tax Credit (RITC) of 75% (an arbitrary rate) which enables the financial institution to claim credit for the GST that is incurred on certain types of acquisitions (including arranger services) for the banking business. The RITC approach is thus an attempt to make neutral the decision of whether the acquisition or arranger service should be done in-house or outsourced.

While the RITC does serve to reduce to some extent, the tax costs and compliance costs for the Australian financial institution, there is the issue of defining the types of services that should fall within the prescribed acquisitions that qualify for the RITC.

Much time can be spent by the financial institution to build systems and processes to identify and track the costs and having to defend the position against the tax authorities' challenge.

New Zealand

The New Zealand government has recognised that the GST exemption of financial services gives rise to the problem of tax cascading and the bias against outsourcing in the banking sector[4] as well as the issue of valuing financial services. As a result, New Zealand introduced the zero-rating of financial services from 1 January 2005 in an attempt to reduce the overall cost of GST to the financial institution.

The treatment in New Zealand is to enable a financial institution to zero-rate a supply of financial services if the supply is made to a GST-registered business with taxable supplies that are equal to or exceeds 75% of its total supplies in a 12-month period. The obvious problem with this approach is that the financial institution has to find some way to determine the level of taxable supplies made by the corporate customer and whether the customer is eligible to receive the zero-rated services. This compliance burden has been alleviated to some extent by various administrative guidelines released by the New Zealand Inland Revenue Department.

The New Zealand approach would have been taken to another level if the GST was introduced in Hong Kong. In the consultation document on broadening the tax base in Hong Kong that was released in 2006, the document raised the possibility of introducing a GST with the comment that "…having regard to the lessons learnt from overseas jurisdictions and global trends, it is proposed that certain financial services to be defined as "financial supplies" be zero-rated…". While the decision has been made to not proceed with a GST in Hong Kong, the proposal for a full zero-rating of financial services would have been a progressive solution to address the impact of VAT/GST exemption on financial services.

Singapore

Singapore follows the traditional approach of exempting financial services with the exclusion of fee-based services in the nature of arranging, broking etc., which are treated as taxable supplies. However, to reduce the financial burden of the GST on the banking sector, the Singapore government has prescribed high input tax recovery rates that range from 76% to 96% (revised each year) depending on the regulatory licence of the financial institution.

[4] GST & Financial Services – A government discussion document, Hon Dr Michael Cullen, New Zealand Minister of Finance, Minister of Revenue, October 2002.

The input tax recovery rates are set by the Ministry of Finance and are believed to be based on loan statistics that are provided by the banks and finance companies to the Monetary Authority of Singapore annually. The rates are meant to be an objective proxy and reflection of the transactions that the financial institution has with retail (individuals) and corporate customers. The broad principle is that the higher the bank-to-business transactions, the higher the recovery rate which explains the relatively lower recovery rate (of say, 76%) for a full retail bank compared to the higher rate (of 96%) for a wholesale or merchant bank. The input tax apportionment formula for the insurance and the securities business largely follows the same broad principle.

It is believed that there is a proposal in Malaysia to adopt the Singapore model of prescribed input tax recovery rates for financial institutions should GST be introduced in Malaysia.

As noted in the early part of this article, the high input tax recovery rates may mean that the banking sector is not a high net contributor to GST revenue in Singapore, but it along with the rest of the financial sector does account for the highest contribution to corporate income tax collections for the Singapore government.

Conclusion

It is clear that the exemption of financial services does not give any advantage to the financial institutions. On the contrary, the denial of GST on the inputs of the financial institution presents a real cost to the banking sector. The financial and compliance impact of the VAT/GST exemption on financial services has been addressed to some extent by some regimes in Asia Pacific such as Australia with its RITC mechanism, in New Zealand with its zero-rated treatment of bank-to-business transactions and Singapore's prescribed input recovery rates for banks.

Whatever the approach, the impact of VAT/GST exemption on financial services in the region should be considered in view of the ability of financial institutions to move to jurisdictions where the cost of doing business is lower, and can be a critical consideration for whether to grow or limit their operations in any jurisdiction.

Koh Soo How
Partner
Indirect Tax (GST)
PwC Singapore
+65 6236 3600
soo.how.koh@sg.pwc.com

Australia

Tax Forum: An opportunity for genuine tax reform?

Over the course of the Tax Forum, many suggestions and ideas were raised covering the full ambit of Australia's tax and transfer system including business taxes, personal taxation, State taxes, tax governance, environmental and social taxes.

On 4 October 2011, the Government held a Tax Forum in Canberra, Australia.

In her opening speech to the Tax Forum, Prime Minister Julia Gillard highlighted five factors that are currently shaping the Australian economy, and noted that tax reform must be considered in the context of these challenges. These are as below:

1. The overhang from the global financial crisis and continuing volatility in the global markets, which have resulted in a loss of confidence and a better understanding of the nature of risk.

2. The 'Asian century', that is, continuing opportunities from growth in Asia and demand for our resources. In particular, the Prime Minister highlighted the challenges created in respect of a two speed economy that is derived from the current resources boom.

3. Globalisation and innovation in information technology and communication.

4. A move to a carbon constrained economy.

5. Australia's ageing population and the burden of disease, and costs associated with these.

Some key matters raised at the Tax Forum were:

- Reducing the corporate tax rate. There was general support amongst business for lowering the corporate tax rate (either a general reduction or targeted to specific industries) to 25 per cent as recommended by the Australia's Future Tax System Review (the Henry Review) to attract mobile capital into Australia.

- Loss utilisation. The current arrangements for corporate tax losses were discussed. A number of reforms were suggested to encourage risk taking in investment decisions, including a two-year loss carry back rule, with refunds limited to a company's franking account balance, reforms to the Same Business Test, which is currently too restrictive, particularly as many businesses need to change their business to become profitable after a period of losses.

- Financial transactions tax. The introduction of a financial transactions tax, such as that currently being considered by the G20, was raised. The Treasurer Wayne Swan did not appear to support such a tax in the Australian economy, highlighting the fact that the consideration of this tax in Europe was aimed at addressing the present debt crisis, a situation which is not replicated in Australia.

Over the course of the Tax Forum, many suggestions and ideas were raised covering the full ambit of Australia's tax and transfer system including business taxes, personal taxation, State taxes, tax governance, environmental and social taxes.

In a welcome move, the Treasurer Wayne Swan, in his closing address to the Tax Forum, indicated that the Government will draw on the priorities identified at the Tax Forum as the building blocks for the next stage of ongoing tax reform and indicated a number of immediate commitments that will be made, including:

- A Business Tax Reform Working Group to be established to firstly consider, as a priority issue, the treatment of losses, and then look at longer term company tax options.

- The Treasury, the Australian Taxation Office (ATO) and the Council of Small Business to work together in the coming months to address concerns around small business tax complexity.

- The Treasurer indicated that a state tax reform plan will be developed in conjunction with the Commonwealth, with the first reforms to be set out by the end of 2012.

- For individuals, the Government indicated that its first priority around personal tax reform will be to increase the tax-free threshold further to at least A$21,000, which should have the objective of having over one million individuals no longer needing to complete income tax returns.

While there are a number of tax reform measures now already under way, it seems that much more change and debate lies ahead.

It is too early to assess whether there will be a genuine tax reform in Australia following the Tax Forum and what impact this might have on banks and financial services business in Australia. There are delicate political and revenue impact issues to consider which may ultimately determine the tax reform agenda.

What compliance activity is the ATO undertaking?

Compliance Program for 2011–2012

On 30 June 2011, the ATO released its Compliance Program for 2011–2012. The Compliance Program outlines the ATO's key risk areas and its strategies to manage those risks.

This year, the ATO is focussing its compliance activities around the following:

- The corporate governance framework of large businesses (turnover greater than $250m).

- International tax risks including the anti-deferral rules, thin capitalisation rules, foreign resident disposals of companies with interests in land and foreign private equity disposals of Australian investments.

- Withholding tax on payments of interest, dividends and royalties to non-residents.

- Transfer pricing risks including business restructures and losses.

- The implementation of the taxation of financial arrangements (TOFA) rules.

- Executives, directors and other highly paid individuals.

Review of offshore bank branch operations

The ATO has also commenced specific reviews of the arrangements between Australian bank head office and foreign bank branches.

The ATO's key risk areas include the following:

1. Whether the Australian bank head office has overstated foreign bank branch income which is exempt from Australian tax.

2. Whether the Australian bank head office has understated expenses relating to exempt foreign bank branch income which are not deductible.

3. Whether the Australian bank head office has complied with its interest withholding tax obligations in respect of foreign bank branch funds transfers (Tax Ruling TR 2996/9).

4. Whether the Australian bank head office has correctly applied the thin capitalisation rules for banks.

5. Whether the Australian bank head office has tainted its offshore banking unit (OBU) with non-OB money in respect of foreign bank branch funds transfers.

Review of the implementation of the TOFA regime

All Australian taxpayers are now subject to the TOFA rules, unless an exception applies. The TOFA rules are concerned with how gains and losses on financial arrangements are determined and the time at which they are brought to account for tax purposes.

The ATO is finalising a TOFA Implementation Questionnaire which has the objectives of reviewing taxpayer compliance with the TOFA rules in the implementation phase and to monitor the extent to which the objectives of the TOFA regime are being met.

The Questionnaire will likely cover:

- Eligibility for making TOFA elections.
- Transactions undertaken just before the TOFA commencement date.
- Details of existing financial arrangements.
- Compliance with specific tax timing and transitional rules.
- Details in relation to hedging policies and tax hedging documentation.
- Procedures for monitoring changes to the TOFA rules.

All Australian taxpayers are now subject to the Taxation of Financial Arrangements rules, unless an exception applies.

- Governance issues associated with the implementation of, and procedures for monitoring changes to the TOFA rules.
- Contentious tax positions adopted.
- Tax indemnities and contingent tax provisions in relation to financial arrangements.
- Application of the accounting standards.

The Questionnaire will be piloted with between 20 and 40 taxpayers with a focus on selected taxpayers that have made a TOFA transitional election and/or TOFA early start election, higher risk taxpayers and then rolled out more generally as part of normal compliance activities. Australia's major banks are unlikely to be included in the pilot.

The Questionnaire is likely to be detailed and require a significant amount of information to be provided to the ATO. The industry is lobbying for a more high level, focused risk-based approach to be adopted by the ATO to its TOFA compliance activities rather than requesting significant information that is unlikely to assist the ATO to identify any specific risks.

Reportable tax position schedule

The ATO is piloting a reportable tax position (RTP) schedule for the 2012 company tax return. The schedule will require large businesses (turnover greater than $250m) that have been notified by the ATO to disclose their most contestable and material tax positions to the ATO. Taxpayers that have been notified will be required to disclose their RTPs.

An RTP is any of the following:

- A material position that is more likely to be correct than incorrect.
- A position in respect of which uncertainty about taxes payable or recoverable is recognised and/or disclosed in the taxpayer's or a related party's financial statements.
- A position in respect of a reportable transaction.

The ATO is currently working with industry groups on a number of issues in relation to how the pilot will work and how the RTP schedule will be subsequently applied to other taxpayers.

The ATO is piloting a reportable tax position schedule for the 2012 company tax return which will require large businesses (turnover greater than $250m) that have been notified by the ATO to disclose their most contestable and material tax positions to the ATO.

Qantas Federal Court Decision – what is a "supply" under GST law?

In *Qantas Airways Limited v Commissioner of Taxation* [2011] FCAFC 113, the Full Federal Court unanimously held that goods and services tax (GST) was not payable by Qantas in circumstances where a person booked and paid for domestic air travel but subsequently cancelled the booking or did not turn up for the flight, and did not receive or collect a refund from Qantas.

The Commissioner argued unsuccessfully that there was a taxable supply for GST purposes when payment of the air travel was made. The Court disagreed and found that what each customer pays for is carriage by air and the actual travel was the relevant supply, and if it did not occur, there was no taxable supply.

This decision has implications for a wide range of taxpayers, including those in the financial services sector.

Financial services providers, including banks should review the contractual arrangements and GST treatment of all payments made and received for an intended purpose which does not take place or fails. This could include:

- Charges on which GST has been paid, but no supply made (which could include taxable transaction break fees, lease termination fees). Refunds of GST may be available and/or GST may not be applicable on such payments going forward.
- Charges that have been treated as input taxed, but no supply is made (which could include loan and derivative break fees). This may impact GST credit recovery through the apportionment methodology where the charges have been included as input taxed revenue which in turn may give rise to refunds of GST and improved GST recovery going forward.

The Commissioner has appealed to the High Court.

Financial services providers should monitor the progress of the appeal to the High Court and determine whether any immediate action should be taken to preserve the retrospective period over which GST refunds can be claimed.

Tax impact of regulatory change

There are a number of current and proposed regulatory changes in Australia and overseas that have a flow-on tax impact for banks and financial services business in Australia. These include:

- The impact of the Basel III capital reforms, including the tax treatment of hybrid debt capital.
- The impact and management of liquidity and funding requirements, including the tax treatment of losses and global charges, expense allocation, thin capitalisation impact and withholding tax issues.
- The impact of changes in the Australian International Financial Reporting Standards, including financial instruments, hedging and leasing.
- FATCA transition and compliance.
- Covered bonds legislation.

Matt Osmond
Partner
PwC Australia
+613 8603 5883
matt.osmond@au.pwc.com

Gavin Marjoram
Partner
PwC Australia
+612 8266 0576
gavin.marjoram@au.pwc.com

China
Recent tax developments

Capital gains from the redemption of State bonds shall be recognised on the interest payment due date as agreed on the date of issuance of State bonds.

Clarifications of Corporate Income Tax treatments for investment in State Treasury Bonds

On 22 June 2011, the State Administration of Taxation (SAT) issued *Public Notice* [2011] No.36 ("PN36") clarifying the Corporate Income Tax (CIT) treatment in relation to investments in State treasury bonds ("State bonds"). PN36 took effect from 1 January 2011 retrospectively.

The salient points of PN36 and our observations as below.

Salient points

- **Interest income from State bonds**

Types of interest income from State bonds			Interest income recognition	CIT implication
Unrealised interest income	1.	Interest accrued before the agreed date of the State bonds interest payment	No need to recognise it as taxable income	Interest income accrued shall be excluded from taxable income for CIT purpose
Realised interest income	2.	Interest income paid by the issuer where the State bonds are purchased from the issuer directly and held till maturity	Recognise interest income on the interest payment due date as agreed on the date of issuance of the State bonds	Interest income received shall be fully exempt from CIT
	3.	Interest income which has not become due during the holding period where the State bonds were sold before maturity	Recognise interest income on the day when the capital gains from the transfer of the State bonds are recognised as income	Interest income entitled to CIT exemption shall be calculated based on the following formula ("Formula A[1]"): Amount of interest income = par value or issuing price of State bonds x (applicable annual interest rate/365) x number of holding days

[1] PN36 sets out how to determine the terms "applicable annual interest rate" and "number of holding days".

• **Capital gains**

Timing for recognition of capital gains

- Capital gains from the State bonds sold before maturity shall be recognised as income on the effective date as agreed in the trading agreement, or on the delivery date of the State bonds.

- Capital gains from the redemption of the State bonds shall be recognised on the interest payment due date as agreed on the date of issuance of the State bonds.

Income nature and calculation method of capital gains

PN36 clarifies that the transfer of the State bonds shall be regarded as a transfer of property as stipulated in the CIT Law and hence the gains or losses from such a transfer should be included in the taxable income subject to CIT.

The gains/losses from a transfer of State bonds is to be calculated as follows ("Formula B"):

> Capital gains/losses = Consideration received from a transfer or a redemption of State bonds – the acquisition cost of State bonds – interest income for the holding period (calculated using Formula A) – relevant trading taxes and expenses incurred

PN36 also sets out how to determine the acquisition cost of the State bonds purchased for cash or non-cash payments. In this respect, PN36 allows the acquisition cost to be determined based on the first-in-first-out method, weighted average method or specific identification method. Once a calculation method has been selected, it shall not be arbitrarily changed.

Our observations

• **Accrued and unrealised interest income for the State bonds shall not be taxable**

For accounting purposes, interest income is accrued over the holding period of the bonds. On the other hand, article 18 of the Detailed Implementation Rules of CIT Law (DIR) as reiterated by PN36 stipulates that for CIT purposes, interest income is recognised as income on the interest payment due dates as agreed with the debtor in the contracts. This seems to create a book-to-tax difference but in practice, such book-to-tax adjustment to exclude the accrued interest income from the CIT taxable income is not common.

• Interest embedded in the sales proceeds of the State bonds transfer is treated as interest income and entitled to CIT exemption

Circular *Caishui* [2002] No.48 (Circular 48) provides that the amount of interest indicated in the delivery order shall be exempt from CIT due to the "net price trading" of State bonds. It is not entirely clear if Circular 48 remains valid in the new CIT regime effective from 1 January 2008. We observed that there was an inconsistent administrative practice in different regions for granting CIT exemption in relation to interest income on State bonds during the previous annual CIT filing. With the clarification provided by PN36, we believe that interest embedded in the sales proceeds of State bonds transfer should be treated as interest income (instead of gains or losses from a disposal of State bonds) and thus the CIT exemption would be available. This is a useful clarification for investors investing in State bonds.

• Capital gains from transfer of State bonds is treated as income from transfer of property

It is probably the first time the SAT has confirmed that capital gains from transfer of State bonds should be treated as income from the transfer of property for CIT purpose.

• Uncertain issues

- Article 1.2 of PN36 does not cover a situation where taxpayers receive interest income paid by the issuers upon the maturity of State bonds for bonds purchased by the taxpayers from non-issuers. However, we think the principle of Article 1.2 should apply to this situation.

- In practice, interest from State bonds may be paid upon redemption, or during the life of the bonds (e.g., annually). It is uncertain how Formula B can be applied to calculate the capital gains derived from the disposal of State bonds that receive periodic interest. This is subject to further clarification from the SAT.

- It is uncertain how PN36 would apply to zero-coupon State bonds.

- PN36 took effect from 1 January 2011 retrospectively. Whether PN36 would apply to the 2010 annual CIT filing made in 2011 is not clear. Taxpayers should monitor the implementation of PN36 and assess whether there is a tax refund opportunity with the local tax authorities for over-paid CIT on the interest income of State bonds for 2010.

Taxpayers should monitor closely local implementation of PN36 and assess whether there is a tax refund opportunity with the local tax authorities for the Year 2010 for over-paid CIT on the interest income of State bonds.

The SAT issued administrative measures in respect of deemed overseas TREs in September 2011. The measures covers application procedure, collection matters, CIT treatment as well as application of double tax treaty provisions.

Impact of [Administrative Measures for Overseas Registered Chinese-capital Controlled Tax Resident Enterprises (Trial)] on financial service industry

The PRC Corporate Income Tax (CIT) Law which took effect from 1 January 2008 introduced the concept of Tax Resident Enterprise (TRE). In April 2009, the SAT released Circular Guoshuifa [2009] No.82 (Circular 82) clarifying the definition of a Chinese TRE for Chinese-capital controlled foreign companies (CCCFC). Circular 82 also provided a general guidance on the CIT treatments, application procedures of TRE status for CCCFCs.

With the aim of standardising the tax administration for the CCCFCs which obtained Chinese TRE status (also known as overseas registered Chinese-capital controlled tax resident, or "Deemed Overseas TREs"), the SAT released the *[Administrative Measures for Overseas Registered Chinese-capital Controlled TREs (Trial)]* Public Notice [2011] No.45 (PN45), on 27 July 2011. PN45, effective from 1 September 2011, covers the significant tax matters of Deemed Overseas TREs, including application procedures of TRE status, documentation requirements, CIT treatment, administration and collection matters and the application of double tax treaty provisions.

The salient points, key features and our observations of PN45 have been covered in the August 2011 Issue 22 of PwC *China Tax and Business News Flash*. The following focuses on the impact of PN45 on financial services industry.

Salient points

- **Scope of PN45**

The scope of PN45 is the same as that defined in Circular 82, i.e., an enterprise established in accordance with the laws of foreign countries (regions) with the main investor being a Chinese enterprise or corporate groups and with its "effective management" located in China.

- **Administration on the recognition of Chinese TRE status**

There are two ways to determine the Chinese TRE status for a CCCFC. CCCFC may lodge the application for Chinese TRE status with Chinese tax authority ("the first approach")or the Chinese tax authority may initiate investigation on a CCCFC to determine whether it should be regarded as a Chinese TRE ("the second approach").

In the case of the first approach, a CCCFC is required to self-determine whether its "effective management" is located in China based on the actual facts of its production, business operation and management. The CCCFC shall lodge the written application for TRE status with the in-charge Chinese tax authority and submit relevant documentation if it satisfies the criteria of TRE stipulated in Article 2 of Circular 82.

As for the second approach, PN45 empowers the Chinese tax authorities to investigate the status of effective management of a CCCFC and to request for relevant documentation, if the CCCFC satisfies the prescribed criteria but fails to apply for a Chinese TRE status.

This will trigger increased China tax exposures in respect of dividends, income from equity transfer etc. derived by investors in CCCFCs that have Chinese TRE status.

• CIT Treatment

PN43 has for the first time clarified that capital gains derived by Non-TREs from a transfer of equity interest in Deemed Overseas TREs shall be treated as China-sourced income in accordance with article 26 of PN45. The Deemed Overseas TRE shall report the equity transfer by presenting the equity transfer arrangement and other related documents to the in-charge tax authority within 30 days from the date of the agreement.

PN45 also stipulates in article 24 that the Chinese in-charge tax authorities shall conduct quarterly reviews of the CIT withholding obligation of Deemed Overseas TREs in respect of dividend, interest, rental, royalties and income derived from property transfer paid to Non-TREs.

Our Observations

• Challenges facing investors of Deemed Overseas TRE

According to Circular 82, CCCFC "may" lodge the application for Chinese TRE status with the in-charge Chinese tax authority. However, under PN45 the CCCFC is obligated to lodge the application and submit required documentation as long as it satisfies the prescribed criteria of a Chinese TRE. On the other hand, PN45 empowers the Chinese tax authorities to initiate investigation on the TRE status of "suspicious" CCCFCs and provides clarification of the relevant procedures.

In light of above, we expect that, with the concept of "TRE" introduced in the CIT law, the Chinese tax authorities would continue to gradually reinforce the recognition of the "Chinese TRE" status and to strengthen the tax collection and administration of Deemed Overseas TREs in China. This will trigger increased China tax exposures in respect of dividends, income from equity transfer etc. derived by investors (especially the Non-TRE investors) as a result of the Chinese TRE status of the invested CCCFCs. Accordingly, Non-TRE investors should consider the impact of the overall tax cost on the effective investment returns should the invested CCCFC be recognised as a Chinese TRE.

However, PN45 does not provide an effective mechanism to keep the Non-TRE investors informed of the TRE status of a CCCFC. It is not clear whether the SAT would make a list of Deemed Overseas TREs publicly available and update it on a regular basis or alternatively provide an enquiry mechanism. Non-TRE investors should pay regular close attention to the Chinese TRE status of the invested or targeted CCCFC, and consider their own Chinese tax implications should the invested or targeted CCCFC be determined as a Chinese TRE.

• Chinese tax implications of Non-TRE investors of CCCFCs being recognised as a Chinese TRE

Dividend

According to Circular 82, dividend and profit distribution from equity investment distributed by Deemed Overseas TREs to Non-TRE investors shall be treated as China-sourced income and subject to withholding income tax (WHT) in China. The source of dividend and profit distributions from equity investment shall be determined by the location of the enterprise that distributes the dividend and profit distribution in accordance with the CIT Law and its DIR. Accordingly, Circular 82 makes it clear that the "location of residency" rather than the "geographical location" or the "location of registration" shall be adopted when determining the location of the enterprise that distributes the dividend and profit distribution.

Capital gains from equity transfer

The source of capital gains from a transfer of equity investment shall be determined by the location of the investee in accordance with the CIT law and its DIRs. PN45 makes it clear that the "location of residency" rather than the "geographical location" or the "location of registration" shall be adopted when determining the location of investee. Such determination by "location of residency" is consistent with that adopted for determining the source of dividend as stipulated in Circular 82. Accordingly, income derived from the transfer of equity in a Deemed Overseas TRE shall be China-sourced income because of the Chinese TRE status of the investee. Such clarification leads to a WHT at 10% on the capital gains from a transfer of equity in a Deemed Overseas TRE for overseas investors, unless treaty protection is available.

Non-TREs shall generally be obliged to report the transfer of equity that is directly or indirectly held in a Chinese TRE to the Chinese tax authorities in accordance with Circular *Guoshuihan* [2009] No.698 (Circular 698). An exclusion was provided to this reporting obligation in Circular 698 for the gains derived from the buying and selling of shares of Chinese TREs through public stock exchanges (the Exclusion). A number of financial institutions and other enterprises have been relying on the Exclusion as the basis that there should be no Chinese tax implications on gains derived from buying and selling of shares of Chinese TREs listed overseas effected through public stock exchanges.

Earlier this year, *Public Notice* [2011] No.24 (PN24) has narrowed the scope of the Exclusion in Circular 698. The term "buying and selling of shares of Chinese TREs effected through public stock exchanges" shall only refer to those transactions whereby the parties to the buying and selling transaction, the quantity of shares being transferred, and the transaction price are not pre-determined upfront between the buyer and the seller, but are determined in accordance with the ordinary trading rules of the public stock exchanges instead. It appears that the SAT would like to limit the Exclusion on gains derived from daily trading of Chinese TRE shares conducted on-exchange where the reporting obligation and tax collection would be regarded as difficult to enforce from an administrative perspective. We are aware of a case in practice whereby the Chinese tax authorities have successfully imposed WHT at 10% on the gains by a Non-TRE from a disposal of shares of a Hong Kong listed "red chip" company (which has been recognised as a Chinese TRE) based on the principle of "location of residency" and the fact that the buying and/or selling was not effected through public stock exchanges.

The aforementioned case and the subsequent clarification in PN45 regarding the determination of the source of capital gains by "location of residency" of the investee would likely have implications for the investors in the financial services industry. Non-TRE investors, (e.g., investment banks, private equity funds) investing in shares of Chinese corporation listed overseas (e.g., H shares) or overseas listed shares of non-Chinese corporations which are subsequently deemed as Chinese TREs, who exit their investments through private placements, block trades and other non-market type transactions may not be able to rely on the exclusion and hence are subject to WHT in China since, typically, the parties to the transaction, the quantity of the shares being transferred and/or the transaction price would be pre-determined upfront between the buyer and the seller.

Investors should be aware of the Chinese tax implications when disposing of shares in accordance with rules in PN45, Circular 698 and PN24, and consider using an entity within the group that has commercial substance and that is located in a jurisdiction that has concluded a favorable double tax treaty with China to hold the CCCFC.

Interest, rental and royalties

The source of interest income, rental and royalties shall be determined according to the location of the enterprise which bears and/or pays the income pursuant to the CIT law and its DIRs. Although PN45 is silent as to how to determine the "location" of the enterprise concerned, we believe that the source of such passive income, which shall be determined by the location of the enterprise which bears and/or pays the income, would also be determined by the SAT according to the "location of residency", based on the clarifications made by Circular 82 in relation to source of dividend and by PN45 in relation to the source of capital gains. As a result, interest, rental and royalties etc. derived by Non-TRE investors from Deemed Overseas TREs may also be subject to WHT in China at the applicable tax rate.

Capital gains from transfer of debt obligation

It is not entirely clear as to the source of capital gains from a transfer of debt obligation in the CIT law and its DIRs. According to article 16 of the DIRs of CIT Law, income from a transfer of a debt obligation shall be treated as income from transfer of property. The SAT *Public Notice* [2011] No.36 (PN36) confirms that a transfer of government bonds shall be regarded as income from a transfer of property. However, clarifications are required as to whether a debt obligation shall be treated as movable property or equity investment in the context of income from a transfer of property. It would be helpful if the SAT would further clarify whether the source of capital gains from a transfer of debt obligation shall be determined by the location of the enterprise that transfers the debt obligation or by the location of the enterprise that issues the debts.

- **Other matters**

How about Chinese-individual controlled and foreign capital controlled foreign companies?

Circular 82 and PN45 only apply to CCCFCs.

We observe that quite a number of Chinese enterprises have adopted a model whereby an overseas company directly or indirectly held by Chinese individuals gets listed on an offshore stock exchanges (e.g., NASDAQ). It is not clear whether Circular 82 and PN45 should be applicable to the determination of Chinese TRE status of these Chinese-individual controlled foreign companies. However, we believe that the current criteria for determining Chinese TRE status of CCCFC, administration and collection of taxation and CIT treatments should serve as good references for Non-CCCFCs in assessing and managing the risk of being regarded as Chinese TREs and potential Chinese tax consequences.

Chinese WHT retrospectively imposed on Non-TRE investors once the invested CCCFC being recognised as a Chinese TRE?

There are two ways to determine the Chinese TRE status for a CCCFC. A CCCFC may lodge the application for Chinese TRE status with Chinese tax authority or the Chinese authority may initiate investigation of a CCCFC to determine whether it should be regarded as a Chinese TRE. In practice, it may be possible for the Chinese tax authority to deem the Chinese TRE status effective from the year in which the CCCFC satisfies the criteria of TRE. In such case, Chinese tax implications of investors would likely to be implemented from the year in which the Chinese TRE status of the invested CCCFC is determined. Then, how about those settled transactions (e.g. equity transfer)? It is unclear whether Chinese WHT would be retrospectively imposed on those Non-TRE investors. Non-TRE investors should keep in mind such potential tax exposure.

We will continue to monitor the developments on how the above rules will be implemented at local-level tax authorities and development in relation to Non-CCCFC and share them with you on a timely basis.

Danny Yiu
Partner
PwC China
+86 (10) 6533 2787
danny.yiu@cn.pwc.com

PN45 and Circular 82 only apply to CCCFCs. It is not clear whether they should be applicable to the determination of Chinese TRE status of Chinese-individual controlled foreign companies.

Hong Kong

Nice Cheer: How much cheer does it really bring to financial institutions?

The IRD argued that under the statutory tax regime and applying the principle established in the Secan case, profits and losses must be ascertained in accordance with ordinary principles of commercial accounting as modified to conform with the IRO.

We all know by now that accounting treatment plays an important role in the determination of the Hong Kong profits tax treatment of an item of income or expense. Although arguably not new, the position was made clear by the Court of Final Appeal on *CIR v Secan Ltd & Ranon Ltd* ("Secan case") which reiterated the principle that the assessable profits or losses of a taxpayer should be *"ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the [Inland Revenue] Ordinance"*. Since then, the assessing practice of the Inland Revenue Department (IRD) has been to follow accounting treatment; a consequence of this is that the IRD have sought to tax any unrealised gains or losses on financial instruments in the year of assessment in which such unrealised gains or losses are recognised in the profit and loss account. Such assessing practice was set out in the *Departmental Interpretation and Practice Notes No. 42 – Taxation of Financial Instruments & Foreign Exchange Differences* (DIPN 42) issued by the IRD.

While the above position has generally been adopted by taxpayers since the release of the DIPN 42, to the surprise of many observers, when the Court of First Instance handed down its judgement in *Nice Cheer Investment Ltd. v CIR* ("Nice Cheer case") on 28 June 2011, doubt was cast in the correctness of that assessing practice. In particular, it was held by the Court of First Instance in that case that unrealised gains on shares held by the taxpayer for trading were not taxable under Section 14(1) of the Inland Revenue Ordinance (IRO).

The Nice Cheer case

Nice Cheer Investment Limited is a private company incorporated in Hong Kong with investment trading as its principal activity. The taxpayer's accounts for the various financial years concerned were prepared in accordance with the prevailing accounting practices and financial reporting standards in Hong Kong. Under those prevailing accounting standards and practices, any unrealised gains or losses arising from the change in fair value of trading stock (being securities listed in Hong Kong) were recognised by the taxpayer in its profits and loss accounts in the relevant financial years.

The taxpayer excluded the unrealised gains in calculating its assessable profits for the relevant years. Its reasoning for doing so was that (i) the word "profits" as used in Section 14(1) of the IRO (the charging section) means real profits and not notional profits; (ii) it is an overriding principle of tax law that profits can only be taxed when in fact they have been earned, realised, ascertained, arisen and derived but cannot be anticipated; and (iii) the accounting standards and principles adopted cannot have the effect of changing the meaning and scope of the word "profits" in Section 14(1).

The IRD argued that under the statutory tax regime and applying the principle established in the *Secan* case, profits and losses must be ascertained in accordance with ordinary principles of commercial accounting as modified to conform with the IRO. In this regard, since (i) the taxpayer's accounts were properly drawn up according to the prevailing accounting standards under which unrealised gains or losses arising from the fair value adjustment of trading stocks were recognised in the taxpayer's profit and loss accounts; and (ii) there is no provision in the IRO expressly prohibiting inclusion of unrealised gain as profits, it was therefore contented by the IRD that the unrealised gains should be taxed at the time when the gains are recognised in the profit and loss accounts.

The Court of First Instance ruled in favour of the taxpayer. This thus poses the question of whether this contradicts with the principle in *Secan*.

In construing the true and proper meaning of the terms "trade", the Court referred to the ordinary meaning of these words and the interpretations applied in other case law.

Reconciling with the Secan case

The Court of First Instance in *Nice Cheer* did not overturn the principle established in the *Secan* case, but clarified that accounting profits become assessable profits only *"in the absence of statutory provisions to the contrary"*. If there are statutory provisions applicable to a particular situation, the law itself and the judge's interpretation of the law take precedence over ordinary commercial accounting principles. In *Nice Cheer,* the issue was whether the unrealised gains arising from the change in fair value of trading stock (being Hong Kong listed securities) held by the taxpayer should be assessed for tax, and this is governed by Section 14(1) of the IRO. It follows that the statutory provisions concerned, i.e. Section 14(1) of the IRO, should have precedence over ordinary commercial accounting principles if the *Secan* case principle is applied correctly. Profits which do not fall into the scope of charge as set out in Section 14(1) of the IRO are not taxable even if they are recognised in the profit and loss accounts pursuant to the prevailing accounting standards.

Section 14

Section 14(1) of the IRO states that *"profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets…)" [emphasis added].*

In analysing whether the unrealised gains arising from the change in fair value of trading stock held by the taxpayer were within this provision, *Nice Cheer* held that the critical point was whether such unrealised gains could be regarded as "profits" derived from a "trade, profession or business" carried on in Hong Kong. In answering this question, the Court had, in turn, to decide the true and proper meaning of the terms "profit" and "trade" for the purpose of the provision.

In construing the true and proper meaning of the terms "trade", the Court referred to the ordinary meaning of these words and the interpretations applied in other case law. On this basis, the Court concluded that the essential elements of "trade" are that *"it is a commercial operation between two parties in which a trader provides goods or services to the other party for reward"*. The Court further held that it is a well established principle of construction of income tax statutes that a man cannot trade with himself and that such principle remains valid in Hong Kong as there is nothing in the IRO which is inconsistent with this principle. Based on the meaning of "trade" as constructed above, the Court considered that the word "profit" in Section 14(1) must be construed to mean profits arising in or derived from commercial transactions, which necessarily means real profits from actual transactions and excludes anticipated profits arising from revaluation of trading stock. Accordingly, the Court held that the unrealised gains arising from such revaluation should be not be chargeable for tax under Section 14(1).

Interestingly, the Court also took the view that while accounting principles applicable to the treatment of profits require modification to conform with Section 14(1) of the IRO, there is no similar qualification as to the word "loss". As such, unrealised losses arising from the devaluation of trading stocks should be allowed for deduction.

Implications of Nice Cheer to financial institutions

Not surprisingly, the IRD has filed an appeal against the decision of the Court of First Instance and the hearing is scheduled for May 2012. Pending the outcome of the appeal, the present judgement by the Court of First Instance represents the latest interpretation of the law by a court on the taxability of unrealised gains or losses arising from the revaluation of trading stock. Taxpayers can therefore consider relying on the Court of First Instance's judgement and excluding the unrealised gains arising from the revaluation of trading stocks while claiming a deduction on the unrealised losses. Having said that, and putting aside the uncertainty given the pending appeal, it is worthwhile to look at how much benefit this change would really bring to a financial institution and the costs and effort required to obtain that benefit.

First of all, an immediate and easy to see benefit of having the gains taxed on a realised basis is the deferral of tax liabilities and tax payments and thus an improvement in cash flow. The savings would be in terms of reduced funding costs, which would vary between institutions, but should nonetheless be advantageous.

In addition, having unrealised gains being taxed at the time of recognition in the accounts might not be just a timing issue. If the unrealised gains turn into smaller realised gains or even losses, taxpayers may suffer permanently in a situation where they are required to pay tax when the unrealised gains are recognised in the accounts, but the losses recognised in the accounts when the gains are subsequently reversed cannot be utilised if the taxpayers do not have other taxable profits at that time. Nonetheless, for an ongoing business, the inability to utilise realised losses should not generally be a concern in practice.

From a financial reporting perspective and in relation to the reporting of the operating results, the change brought about by the *Nice Cheer* case, however, may mean little to financial institutions since such institutions, instead of making provision for current tax liabilities only, would still need to make provisions for deferred tax.

On the other hand, in pursuing a tax filing position of excluding unrealised gains, taxpayers would need to keep track of the amount of such excluded gains and losses and the amount of realised gains and losses for financial instrument, from the time of purchase until the time of disposal. This may or may not, however, be an easily achievable task in practice depending on the internal systems of each entity. In any event, this is likely to result in a significant additional burden on the financial control and tax departments of institutions.

It will be interesting to see how *Nice Cheer* will develop in the higher courts. If the judgment of the Court of First Instance ultimately prevails, the tax filing and reporting process for financial institutions in Hong Kong may become more complex, although cash flow advantages will be reaped. On the other hand, it remains to be seen whether the IRD would allow institutions who prefer not to upgrade their systems to track the excluded unrealised gains, to continue to file returns on an unrealised basis.

David Kan
Partner
PwC Hong Kong
+852 2289 3502
david.kh.kan@hk.pwc.com

Roy Phan
Manager
PwC Hong Kong
+852 2289 3551
roy.ck.phan@hk.pwc.com

Indonesia
Recent tax developments

The enforcement of the transfer pricing legislation in Indonesia in relation to services and other transactions within the financial services industry has been strengthened.

1. Transfer Pricing Landscape

The enforcement of the transfer pricing (TP) legislation in Indonesia in relation to services and other transactions within the financial services industry has been strengthened. The current focus of the Indonesia Tax Authority (ITA) is on the fairness, presence and actual benefits of service fee, royalty, interest compensation and asset transfers within related party transactions. The ITA also closely examines whether the value of the service is arm's length, constitutes duplication, is a normal shareholder cost or is attributable to functions performed by a related party.

With respect to disclosure and documentation, the ITA requires related party disclosures on the Corporate Income Tax Returns and for companies to prepare contemporaneous TP documentation outlining the selection of the specific TP method, comparability analysis as well as function, asset and risk (FAR) analysis to support the arm's length principle within related party transactions.

Specific guidelines on reporting and for the preparation of TP documentation are contained in the ITA regulation No. PER-43/PJ/2010 and provide that:

1. The documentation should largely follow OECD Guidelines (1995 version, not 2010 version)

2. The comparability analysis should be based on five OECD comparability factors:

    a. Product/service characteristics
    b. Functional analysis
    c. Contractual terms
    d. Economic circumstances
    e. Business strategies

3. Internal comparable data is to be preferred over external comparable data

4. The following hierarchy of methods is required: Comparable Uncontrolled Price (CUP), resale price and cost plus methods preferred over profit split and Transactional Net Margin Method (TNMM)

5. Inter quartile range is accepted

6. An exemption from preparing TP documentation is available if the relevant transactions are with a related party which has income or expenses of less than Indonesian Rupiah (IDR) 10 million (circa USD 1,200)

7. The format of TP documentation may be determined by taxpayer; however, it needs to meet the minimum requirements set by the ITA, which are that it must:

    a. Contain a company overview, such as group structure, organization chart, shareholding structure, business operations, list of competitors and description of business environment;

    b. Identify a price policy and/or cost allocation policy;

    c. Set out a comparability analysis (i.e. based on the five comparability factors);

    d. List the selected comparables', and

    e. Explain the application of the selected method.

Following the issuance of the Transfer Pricing guidelines, the ITA has prescribed guidelines on the implementation of the Mutual Agreement Procedures and Advanced Pricing Agreement.

2. Mutual Agreement Procedures (MAP)

Following the issuance of the TP guidelines, the ITA has prescribed guidelines on the implementation of MAP and Advanced Pricing Agreement (APA).

In accordance with the issued regulation, MAP is conducted as a result of:

1. A request by a resident taxpayer of Indonesia;
2. A request by an Indonesian citizen who has become a resident taxpayer of a tax treaty partner country in relation to the non-discrimination provision in the applicable treaty;
3. A request by a treaty partner country; or
4. Matters considered important by and based on the initiatives of the ITA.

An MAP request by an Indonesian resident taxpayer can be made, among other reasons, when:

a. The Indonesian resident taxpayer is subject to or will be subject to tax as a result of the application of TP rules in relation to transactions made with a related taxpayer in a treaty partner country;

b. The Indonesian resident taxpayer believes that action by a tax authority of a treaty partner country has resulted, or will result, in tax imposition which is not in accordance with the relevant tax treaty in relation to the existence of, or income of, a permanent establishment in the treaty partner country concerned;

c. The Indonesian resident taxpayer believes that action by a tax authority of a treaty partner country has resulted, or will result in, tax imposition which is not in accordance with the relevant tax treaty regarding tax withholding in the treaty partner country; or

d. The Indonesian resident taxpayer, who is also considered a resident taxpayer of another treaty country, requests a consultation to determine its status as a taxpayer of one of the treaty countries.

A treaty partner country may request a MAP consultation in, amongst other situations, the following cases:

a. The ITA issues tax assessment letters to a foreign taxpayer that has a permanent establishment in Indonesia, which are considered not to be in accordance with provisions in a relevant tax treaty;

b. There is a TP adjustment in Indonesia in relation to the foreign taxpayer that has a permanent establishment in Indonesia;

c. A tax treaty partner country asks for corresponding adjustments in relation to TP adjustments made by a tax authority of the treaty partner country to its resident taxpayer that has related party transactions with an Indonesian resident taxpayer;

d. Where tax is withheld by an Indonesian resident taxpayer in relation to income sourced in Indonesia which is considered not to be in accordance with provisions in a relevant tax treaty; or

e. Where the domicile country of a taxpayer that has status both as an Indonesian resident taxpayer and as a resident taxpayer of the treaty partner country (Dual Residence) must be determined.

It worth noting that where a foreign taxpayer and related party in Indonesia are contemplating submitting an MAP request, they will also need to consider the MAP guidelines and requirements in the foreign jurisdiction.

3. APA

To request and to negotiate an APA, an Indonesian taxpayer needs to follow the five main steps below:

Step 1 : Pre-lodgement meeting between the ITA and the taxpayer

Step 2 : Filing a formal APA request to the ITA based on the pre-lodgment meeting

Step 3 : Discussion of the APA between the ITA and the taxpayers

Step 4 : The issue of the APA letter by the ITA

Step 5 : The implementation and evaluation of the APA

A taxpayer who has entered an APA must submit an Annual Compliance report (ACR) to the ITA within four months after the end of the fiscal year containing the following:

a. The compliance of the taxpayer with the TP method as described in the APA;

b. A detailed explanation concerning the accuracy and consistency of the TP application; and

c. A detailed explanation of the accuracy of the factors that may impact on critical assumptions in applying the selected TP method.

After the APA issuance, the ITA has the authority to reconsider or cancel the APA in the following circumstances:

a. if the taxpayer does not comply with the APA;

b. if the taxpayer delivers incorrect data/information to the ITA;

c. if the taxpayer does not submit an ACR or the submitted ACR is not in accordance with the prevailing provisions;

d. if a critical assumption is breached;

e. if errors are found in the APA; or

f. if the taxpayer has been involved in a tax crime.

There are numerous technical tax and administrative issues arising from the implementation of the GAAPs which the financial industry associations are currently discussing with the ITA.

These conditions must be included in the APA. Should the ITA cancel the APA, it is required to inform the taxpayer in writing.

Once agreed, an APA can also be applied to tax years before it was agreed if the following conditions are met:

a. the tax year has not been audited;

b. the taxpayer has not filed an objection or appeal for the respective tax year; and

c. there is no indication of tax crime.

Rollback of an APA to prior years is not automatic and will be subject to agreement between the taxpayer and the ITA.

The current regulation, however, does not discuss the procedures for renewing an APA that has expired after the original three year term.

4. Tax Implications of the Implementation of the Indonesia GAAP No. 50 and No.55 (adopted from the IAS 32 and 39 re: Disclosure, Presentation, Recognition and Measurement of Financial Instruments)

The above Indonesia GAAPs have been effective since 1 January 2010. There are numerous technical tax and administrative issues arising from the implementation of the GAAPs which the financial industry associations are currently discussing with the ITA. The notable key tax issues are as follows:

1. Tax treatment of unrealised gain/ loss due to mark to market (MTM) trading securities for Available for Sale (AFS)
2. Tax treatment of provision for loan losses including loan impairment
3. Interest income recognition on non performing loans
4. Recognition of interest subsidy on employee loans
5. Tax treatment of transaction costs and commission
6. De-recognition of financial instruments
7. Retained earnings adjustment

Until further clarification and technical guidelines are provided by the ITA, taxpayers should adopt individual technical positions in relation to their applicable transactions when preparing the 2011 Corporate Income Tax Returns (deadline for the Returns submission is April 2012).

5. Implementation of Withholding Tax Mechanism on Bonds

New regulations concerning withholding tax on bonds were issued and became effective on 23 May 2011 *MOF Decree No.85/PMK.03/2011* ("PMK 85").

PMK-85 is applicable to bonds (including government bonds) issued in Indonesia with maturity periods longer than twelve months. PMK-85 provides more detailed implementation rules in relation to the withholding tax (WHT) mechanism for bond transactions, including WHT rates, deadlines, details pertaining to the tax withholder and the mechanism to be used as well as other matters. Nonetheless, there were no fundamental changes to the basic withholding tax provisions.

Key Changes:

1. The First in First Out (FIFO) method – now mandatory

   Under the previous regulation, the FIFO method was required to be used when determining the acquisition cost and date of a bond sale transaction only for scrip-less bonds where the acquisition date could not be determined. Now the FIFO method must be used for all transactions.

2. Netting of Losses is now prohibited

   When calculating the final income tax due, netting off of interest income against a loss incurred in a sale transaction (i.e. the selling price being lower than the acquisition price) is now prohibited.

6. Islamic Finance – new regulations on Sharia income tax

New regulations concerning Islamic Finance have been issued (effective on 19 August 2011) which serve as the implementing regulations of the previous regulation.

- *Minister of Finance Decree No.136/PMK.03/2011* ("MoF-136") – Income Tax Treatment of *Sharia*-based Financing Activities

  MoF-136 defines *Sharia* financing companies as non-bank financial institutions which conduct financing activities based on *Sharia* principles.

  Sharia principles are defined as Islamic law principles based on a *Fatwa* (edict) that is issued by an institution authorised to issue a *Sharia Fatwa*. Therefore, taxpayers need to ensure that any structure used under a *Sharia* transaction is based on a *Fatwa*.

  MoF-136 also provides definitions of the types of agreement and structures used in *Sharia* financing activities. The tax treatments are summarised below:

Type of activity	Type of agreement	Tax treatment
Lease	*Ijarah*	Similar to Operating Lease
	Ijarah Muntahiyah Bittamlik (IMBT)	Similar to Financial Lease with Option Rights
Factoring	*Wakalah bil Ujrah*	Gain or fee is treated as interest
Consumer financing	*Murabahah*	Gain or profit margin is treated as interest
	Salam	
	Istishna	
Credit card	Not specified	Fee or any other income is taxed in accordance with the Income Tax Law No. 36/2008 ("ITL")
Other *Sharia*-based financing		
Corporate financing	*Mudharabah*	Gain and/or profit sharing derived by financiers *(Shohibul maal)* is treated as interest
	Mudharabah Musytarakah	
	Musyarakah	

The deductibility of expenses is based on articles 6 and 9 of the ITL, including the gain and/or profit sharing payable by the financing company to the *Shohibul maal,* and the agreed amount in the *Sharia* agreement.

- *Minister of Finance Decree No.137/ PMK.03/2011* ("MoF-137") – Income Tax Treatment of *Sharia* Banking

MoF-137 categorises banks' customers under three categories:

- Investor customers –customers who place their funds in a *Sharia* bank or *Sharia* business unit in the form of investment.
- Saving customers – customers who place their funds in a *Sharia* bank in the form of savings. Savings are defined as funds entrusted by the customer to the *Sharia* bank in the form of a demand deposit (giro), saving account, time deposit, or in some other similar form.
- Facility receiving customers (Debtor) – customers who receive a fund facility or other similar facility.

MoF-137 defines the tax treatment based on the type of income, and based on the recipient of the income. The tax treatment can be summarised as follows:

Type of income	Tax treatment	
	Bank	Investor/Depositor Customer
Bonus, profit sharing, and profit margin:		
• from a debtor transaction	Income is treated as interest	
• from a transaction other than a debtor transaction	Income is treated in accordance with the normal income tax regulations for the relevant transaction	
Bonus, profit sharing, and any other income from funds entrusted or placed, and funds placed offshore through an Indonesian *Sharia* bank or an Indonesian branch of an offshore *Sharia* bank		Income is treated as interest
Customer's income other than that covered by the previous point		Income is treated in accordance with the normal income tax regulations

Both MoF regulations stipulate that if there is a transfer or lease of an asset which is required to fulfill the *Sharia* principle, the following rules apply:

- Transfer of an asset from a third party that is carried out merely to fulfill the *Sharia* principle in the financing activities by the financing companies does not fall under the definition of transfer of asset as stipulated in the ITL.

- The transfer of an asset as defined above will be considered to be directly from the third party to the financing companies'/banks' customer, who will be subject to normal income tax.

These MoF regulations only govern *Sharia* transactions carried out by banks and financial institutions. The question remains of whether other types of company, such as an intermediary company in a *Sukuk* transaction, can rely on the same tax treatments under these regulations. Further, no implementing regulation has been issued for other types of Islamic finance activities such as insurance.

Margie Margaret
Partner
PwC Indonesia
+62 21 52890862
margie.margaret@id.pwc.com

Ivan Budiarnawan
Associate Director
PwC Indonesia
+62 21 52890312
ivan.budiarnawan@id.pwc.com

Philippines
The real estate investment trust law

The REIT Act was one of the most anticipated pieces of legislation of recent years as it finally provided the legal and regulatory framework for the establishment of REITs in the Philippines.

On 12 March 2010, Republic Act No. 9856, otherwise known as the Real Estate Investment Trust (REIT) Act, came into effect. The REIT Act was one of the most anticipated pieces of legislation of recent years as it finally provided the legal and regulatory framework for the establishment of REITs in the Philippines with the intent of promoting the development of the local capital markets as an instrument to help finance and advance infrastructure projects.

Under the REIT Act, a REIT can be established as a stock corporation under Philippine law principally for the purpose of owning income-generating real estate. However, foreign investment is limited to 40% of a REIT's voting shares of stock in compliance with Constitutional restrictions on land ownership.

General requirements and incentives

Under the REIT Act, the general requirements to set up a REIT are as follows:

- The REIT must be publicly listed and registered with the Securities and Exchange Commission (SEC)
- The paid up capital of the REIT must be at least Three hundred million pesos (Php 300,000,000)
- Public ownership in a REIT must comprise at least 1,000 public shareholders owning at least 50 shares each, of any class of shares who in the aggregate own at least 1/3 of the outstanding capital stock of the REITs
- 75% of the total value of the REIT's assets must be invested in, or consist of income-generating real estate
- Investment of the REIT in property development activities or uncompleted property developments shall be limited to 10% of the REIT's deposited property

REITs have been granted various tax incentives under the law, including:

- Dividends distributed can be claimed as tax deductions.
- Not subject to Minimum Corporate Income Tax (i.e., 2% of gross income if higher than regular 30% corporate income tax)
- Reduced Creditable Withholding Tax of 1% on Income payment to REITs
- Reduced documentary stamp rate (DST) and registration fees on sale/transfer of real property including security interest related to REITs (50% of the regular DST and registration fees)
- Exempt from Stock Transaction Tax (STT) on any initial public offering and secondary offering of shares (STT rate 1% to 4%)

REITs are not considered as dealers in securities and, as such, are not subject to the 12% VAT on sale of securities forming part of its real-estate related assets.

- 10% final tax on dividends paid by a REIT unless:

  a) The dividends are received by a non-resident individual and non-resident foreign corporations entitled to claim a lower treaty rate

  b) Dividends received by a domestic corporation or resident foreign corporation which are exempt from income tax.

  c) Dividends paid to overseas Filipino workers which are not subject to income tax/ withholding tax for 7 years from the effectivity of the tax regulations implementing the REIT Act (i.e., 11 August 2011).

- REITs are not considered as dealers in securities and, as such, are not subject to the 12% value-added tax (VAT) on sale of securities forming part of its real-estate related assets.

To avail itself of the tax incentives, a REIT should:

- Remain a public company as defined in the REIT Law,

- Maintain the listed status of its securities, and

- Distribute at least 90% of its distributable income to its shareholders annually.

Subsequent regulations

In order to properly realise the potential of the REIT Act, implementing rules and regulations (IRR) were issued by the particular government agencies involved in the regulation of corporations and collection of revenue, the SEC and the Bureau of Internal Revenue (BIR), respectively.

SEC IRR

The SEC IRR, issued on 13 May 2010, was received by potential investors without any major complaints as this initial version closely paralleled the original law.

On 27 April 2011, however, following discussions with the Department of Finance and the BIR, SEC Memorandum Circular No. 2 was issued amending the IRR, to provide for higher public ownership requirements, modification of allowable investments and restrictions on the use of capital to pay debts. The amendments were made despite concerns raised by the business community due to apparent inconsistencies with the REIT Act.

BIR Revenue Regulations (RR)

RR No. 13-2011, which became effective on 11 August 2011, provided for a higher public ownership requirement for REITs in line with the SEC IRR. It is set at forty percent (40%) for the first two years and increased to sixty-seven percent (67%) on or before the third year and thereafter. This was a departure from the REIT Act which only provided for "at least 1,000 public shareholders owning at least 50 shares each of any class of shares and who in aggregate own at least 1/3 of the outstanding capital stock."

Additionally, RR No. 13-2011 required the placing in escrow, in favor of the BIR, the following amounts subject to its compliance with the requirements of the regulations:

- In relation to the reduced rate of DST – the 50% DST waived as a tax incentive, until the public listing requirement with the local stock exchange has been fulfilled within two years from the date of the execution of the transfer documents.

- In relation to allowed tax deduction on dividend distributions – the income tax waived due to the deduction of dividends distributed for the first and second year, until proof of attainment of the minimum public ownership of 67% within three years.

The BIR's adoption of higher public ownership requirement in REITs and the institution of additional compliance measures by way of mandatory escrows as provided in RR No. 13-2011 have led some potential investors and property developers to postpone their plans to establish a REIT.

Conclusion

The initial passage of the REIT Act was seen as a positive step in allowing the local real estate and capital markets to keep pace with investor appetite and international developments.

However, existing regulatory inconsistencies and delays in implementation are a cause for concern and should be settled in order to provide certainty to potential investors in relation to their prospective investments in the Philippine real estate market.

Until these regulatory inconsistencies are resolved, investors are bound to consider whether potential benefits from establishing a REIT in the rising Philippine real estate market will outweigh any potential disadvantages from the current uncertain regulatory environment.

Malou P Lim
Partner
PwC Philippines
+63 2 459 2016
malou.p.lim@ph.pwc.com

Taiwan
Recent tax developments

In recent years, M&A activity in Taiwan's financial services industry has been commonplace, with foreign banks being significant players through seeking to expand their operations in Taiwan.

This article looks at some of the recent tax developments that may have a direct influence on the Taiwanese Banking & Capital Markets (BCM) sector.

Deduction of amortisation of business rights

In recent years, merger and acquisition (M&A) activity in Taiwan's financial services industry has been commonplace, with foreign banks being significant players through seeking to expand their operations in Taiwan. As a consequence of such M&A activities, the acquiring banks may record intangible assets (such as branch office license and goodwill) in their books.

Article 60 of the Income Tax Act (ITA) provides that the cost of acquired business rights may be amortised for income tax purposes over a period of 10 years. In the past, there have been controversies between taxpayers and the tax authorities on the recognition of "business rights" for tax amortisation purposes. Some taxpayers have taken the stand that the right to operate a business should fit the term "business rights" under article 60 of the ITA, and thus amortisation on such rights should be tax deductible.

On 12 August 2011, *Tax Ruling Tai-Tsai-Shuei No. 10004073270* was issued which expresses a more conservative view and limits the interpretation of the term "business rights" to those rights explicitly regulated by law. Examples of such laws mentioned in the ruling include the Statute For Overseeing Private-Owned Public Utilities and the Electricity Act. Currently, intangible assets such as "trademarks", "copyrights", and "patents" are regulated and defined under the Trademark Act, Copyright Act and Patent Act respectively and, therefore, these intangible assets may be amortised under the current tax regulations.

Although *Tax Ruling Tai-Tsai-Shuei No. 10004073270* has attempted to define the term "business rights", it has provided no specific guidance on the treatment of business rights in relation to the financial services industry. This is unfortunate given the amount of M&A activity in the sector in recent years and the large amounts paid for banking licenses and other rights to operate businesses in Taiwan. Accordingly, it remains to be seen whether this new ruling will bring any much needed clarity to the issue of amortisation of rights in relation to the financial services industry.

Deduction of management fees allocated to a Taiwanese subsidiary

In theory, a Taiwanese subsidiary of a foreign company is not eligible for general and administrative (G&A) expense allocation under article 70 of the Assessment Rules for Income Tax Returns for Profit-Seeking Enterprises, as this is only applicable to branches.

This is a major tax issue for foreign banks that have subsidiaries in Taiwan, especially when the amount of allocated head office expense is significant. According to the Ministry of Finance (MOF) administrative appeal case No. 09913023660 dated 20 January 2011, the MOF ruled that the management fees allocated by the foreign parent company to the Taiwan subsidiary should be tax deductible if:

(a) The criteria for allocating the management fees are in accordance with the economic substance of the transaction. In addition, the participants in the management fee allocation are required to have a reasonable anticipation of deriving benefits from the services provided by the foreign parent company, and the management fee allocated is required to be in proportion to the anticipated benefits derived therefrom;

(b) The transaction conforms with regular business practice and is conducted at arm's length; and

(c) The transaction does not involve the payment or receipt of royalties.

Introduction of thin capitalisation rule

The new thin capitalisation rule does not apply to banks, credit cooperatives, financial holding companies, bills finance companies, insurance companies and securities companies.

In January 2011, Taiwan introduced the thin capitalisation rule in the revised article 43-2 of the ITA. From 2011 onwards, deductible interest expense on inter-company loans is capped at a prescribed inter-company debt-to-equity ratio of 3:1 as currently determined by the MOF. The new thin capitalisation rule does not apply to banks, credit cooperatives, financial holding companies, bills finance companies, insurance companies and securities companies.

Reduced business tax rate on services by foreign financial institution

Amongst the various amendments to the Value-added and Non-value-added Business Tax Act ("Business Tax Act") announced in early 2011 is the reduced business tax rate applicable to Taiwanese financial institutions with respect to certain services purchased from foreign business entities.

Pursuant to the revised article 36 of the Business Tax Act, where a Taiwanese financial institution (including companies engaged in banking, insurance, investment trust, securities, futures, commercial paper and pawnshops) purchases services exclusively for its authorised businesses from a foreign financial institution with no fixed place of business in Taiwan, the services are liable for a 3% (previously 5%) gross business receipts tax (GBRT). For services purchased other than the authorised businesses of a financial institution, 5% GBRT will be imposed.

The revised article 36 of the Business Tax Act also provides for a de minimis exemption on a limited amount of services purchased from a foreign enterprise. The current threshold is NTD 3,000 per same item of service purchase.

Based on current timelines, Taiwan listed companies and financial institutions are required to adopt IFRS in 2013. The conversion to IFRS may have a material tax impact for financial institutions.

Large-scale audit on business tax from 1 April 2011 onwards

On 1 April 2011, the Taipei National Tax Administration started conducting large-scale audits of business tax [value-added tax (VAT) and GBRT] including financial institutions that have failed to pay business tax imposed on services purchased from foreign business entities, under-reported sales amount on business tax returns, or are considered to have intended to evade business tax.

Transfer pricing audit trend

In September 2011, the National Tax Administration (NTA) announced their intention to conduct large-scale transfer pricing (TP) audits for the financial years 2009 and 2010. In the BCM sector, banks have been selected as TP audit targets. As such, taxpayers should ensure that robust TP documents are in place and re-visit the scope of their TP reports which should include all related parties transactions as well as transactions booked under the Offshore Banking Units (OBU).

Conversion to IFRS

Based on current timelines, Taiwanese listed companies and financial institutions are required to adopt International Financial Reporting Standard (IFRS) in 2013. For enterprises operating in other industries, adoption of IFRS will apply in 2015[1].

The conversion to IFRS in 2013 may have a material tax impact for financial institutions. For the BCM sector, one example of the issues discussed is the recognition of interest income from moneylending under IFRS 9 'Financial instruments'.

IFRS 9 replaces the multiple classification and measurement models for financial assets in International Accounting Standards (IAS) 39, 'Financial Instruments: Recognition and measurement' (referred to in Taiwan as GAAP 34), with a model that has only two classification categories: amortised cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual cashflow characteristics of the financial assets.

[1] Credit card companies, and insurance agencies and brokerage companies are excluded from the requirement to convert to IFRS in 2013, and may instead defer adoption until 2015.

Under IFRS 9, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time, which resulted in a lower effective interest rate compared to that under IAS 9 or Taiwan GAAP 34. A lower effective interest rate implies a lower amount of interest income booked periodically which may affect the tax base for business tax purposes.

Although the conversion date is drawing near, the regulatory authority and tax authority have not yet provided any proposals to address the potential issues faced by Taiwanese financial institutions upon convergence to IFRS.

Introduction of luxury tax

The Specifically Selected Goods and Services Tax Act (also known as Luxury Tax), effective from 1 June 2011, was promulgated by the Presidential Office on 4 May 2011. It was introduced with the main aim of curbing real estate speculation, though applies more broadly to a basket of high-end goods and rights.

In accordance with the provisions of the Luxury Tax Act, tax at the rate of 10% – 15% of the gross proceeds will be imposed where selected goods and rights are sold within two years of acquisition by a taxpayer. It potentially applies to transfers of:

- Land and buildings;
- Upscale automobiles with taxable values of not less than NT$3 million;
- Yachts with taxable values of not less than NT$3 million;
- Airplanes, helicopters and ultra-light vehicles with taxable values of not less than NT$3 million;
- Turtle shells, hawksbill, coral, ivory, furs, and their products with taxable values of not less than NT$500,000 (excluding those that are not protected species under the Wildlife Conservation Act, or products made from them);
- Furniture with a value exceeding NT$500,000;
- Any membership rights with a selling price of not less than NT$500,000, except when in the nature of a refundable deposit.

As the main purpose of the luxury tax is to curb short-term real estate speculation, some exemptions are provided for transfers which do not have a profit making character. This includes transfers arising upon foreclosure, testamentary transfer of property, gifts and first-time transfers of real property after completion of construction.

The introduction of luxury tax may impact the nature and timing of investment or divestment decisions. As luxury tax is imposed on gross proceeds from the sale, banks, asset managers and wealth management service providers dealing with selected goods (particularly real estate properties) should be aware of the luxury tax impact on their own investment portfolios as well as of their clients'.

Table 1

Country	Dividends (%)	Interest (%)	Royalties (%)
Hungary	10	10	10
France	10	10	10
India	12.5	10	10
Slovakia	10	10	5, 10

Richard Watanabe
Partner
PwC Taiwan
+886 2 2729 6704
richard.watanabe@tw.pwc.com

New tax treaties

At present, Taiwan has signed 22 comprehensive tax treaties, of which 4 were signed in years 2010 and 2011. The new tax treaties signed are with Hungary, France, India and Slovakia. **Table 1** summarises the main contents of the said tax treaties:

For foreign residents with no tax treaty protection, dividends, interest and royalties will be subject to 20% withholding tax.

Signing of Taiwan's first Bilateral Advance Pricing Agreement

The NTA has recently announced that, Taiwan's first Bilateral Advance Pricing Agreement (the "Bilateral APA") was signed on 5 September 2011. The agreement was the culmination of collaborative efforts by all parties, after going through the various stages of the Bilateral APA application process which encompasses regular communication between the NTA and the applicant through its application agent, PwC Taiwan, followed by various discussions and negotiations between the tax authorities of the two jurisdictions.

The completion of the Bilateral APA is a milestone in international tax developments in Taiwan, and a positive development in the mitigation of cross-border tax risks and the creation of a favorable tax environment. With its conclusion, the first Bilateral APA in 2011 clearly signifies Taiwan's openness to mutual agreement of Bilateral APAs and a further sign of Taiwan's readiness to embrace international cooperation in tax administration.

The APA mechanism can be an effective tool for resolving TP issues and minimising TP disputes through collaboration between taxpayers and the tax authorities. Multinational corporations are encouraged to explore the mechanism and potential tax benefits of APA.

United States

FATCA: Assessing the implications for financial institutions in Asia

Although substantial portions of the law's implementation remain unwritten, the statutory definitions are broad, placing many entities that ordinarily would not be considered financial institutions within FATCA's scope.

In an effort to crack down on tax evasion by US citizens and residents, the United States has enacted new information reporting and tax withholding requirements for non-US financial institutions globally. The Foreign Account Tax Compliance Act (FATCA) requires financial institutions to employ enhanced due diligence procedures to identify US persons who may be using non-US financial accounts or entities to evade US taxes.

Although substantial portions of the law's implementation remain unwritten, the statutory definitions are broad, placing many entities that ordinarily would not be considered financial institutions within FATCA's scope.

Death of bank secrecy?

FATCA was enacted in March 2010 in response to the perception that US persons are evading US tax requirements by not declaring all of their global sourced income. The US government estimates that this costs billions in lost tax revenues annually. FATCA is an all-encompassing requirement; the ramifications for financial institutions that do not move quickly to understand the implications may be massive come 2013, when the phase-in of FATCA's provisions begins.

Non-compliance can mean a withholding tax of up to 30 percent on payment flows, both gross and profits sourced, and also payments from FATCA-compliant institutions to non-compliant institutions. For most, this means that non-compliance is not an option.

To comply, virtually all foreign financial institutions (FFIs) in Asia need to adopt procedures designed to identify potential US taxpayers and disclose specific information about them to the US Internal Revenue Service (IRS).

Globally, there also is a broader move by tax authorities to combat tax evasion. For example, Germany and Switzerland recently concluded a treaty to facilitate the identification of undeclared deposits. Last month, the United Kingdom finalised a similar treaty with Switzerland. In the wake of FATCA and these anti-tax evasion efforts by other jurisdictions, one may well argue that the end of bank secrecy and customer privacy rules is near. What is certain is that tax evasion will be far more difficult.

Burdensome requirements

To avoid FATCA's withholding tax, a non-US financial institution must enter into an FFI agreement with the IRS. Under the terms of the agreement, it will need to implement a prescribed process to identify individual account holders who are US citizens or residents, and, in the case of an FFI that is an account holder, verify FATCA compliance. For payments made to non-financial foreign entities (NFFEs), the financial institution will need to obtain the name, address, and tax identification number of each US owner, or a certification from the NFFE that there are no US owners.

The timeline for implementing FATCA is tight; financial institutions must have entered into an FFI agreement on or before 30 June 2013 in order to avoid being subject to withholding tax on 1 January 2014.

Financial services entities and accounts in-scope

FATCA defines a FFI as any non-US entity that:

1. accepts deposits in the ordinary course of a banking or similar business;

2. holds financial assets for the account of others as a substantial portion of its business; or

3. is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests or commodities.

Thus, many entities that ordinarily would not be considered financial institutions – including hedge funds and private equity funds – will be required to comply with FATCA's identification, reporting and withholding provisions.

Challenges

Although some guidance has been issued, substantial portions of the law's implementation remain unwritten. In the face of FATCA's tight timeline, FFIs will be forced to adapt quickly once additional guidance is issued.

Based on the information available, FATCA compliance is likely to require FFIs to:

1. increase the amount of information they collect from new and existing account holders; and

2. adopt follow up action to ensure that all required forms and information is kept current. This will require FFIs to build, sustain and ease account holders in to a culture where they become accustomed to regular requests and updates for information.

The clock is ticking

The timeline for implementing FATCA is tight; financial institutions must have entered into an FFI agreement on or before 30 June 2013 in order to avoid being subject to withholding tax on 1 January 2014. Further, by the effective date of the FFI agreement, a participating FFI must have put into place the requisite identification procedures for new policies/accounts.

Faced with FATCA's burdensome requirements, institutions and industry groups have been lobbying Washington to mitigate the legislation's impact. However, the extent to which the US Treasury will bow to this pressure remains unclear.

Whilst the IRS has promised detailed guidance, in the form of regulations, on the implementation of FATCA, it appears that these may not be issued until mid-2012. Despite the lack of clarity, there is no indication from the IRS that the effective dates will be extended beyond those set out in the recently issued Notice 2011–53. This cuts two ways. On one hand, it permits continued lobbying by financial institutions to soften FATCA's blow. On the other, it means that FFIs will have less time to incorporate the finalised requirements into their businesses.

FATCA has no silver lining; only cost to the business; but the potentially greater costs of non-compliance – on FFIs and their account holders – means that most financial institutions in Asia will need to be compliant, and they should begin planning. For those who already have started to assess the impact, it quickly has become clear that this is not a simple, flick-of-the-switch project, but one that requires a coordinated, group effort.

Next steps

Some institutions in Asia have questioned the broad reach of the FATCA provisions and are adopting a wait-and-see approach in the hope of additional exceptions, carve-outs or repeal. Others have waited, pending the release of regulations by the IRS.

Although many of the details about FATCA's requirements remain unclear, there are a number of steps companies can, and should, take now to prepare for FATCA. As FATCA will affect processes and systems enterprise-wide, and will require new and expanded information and reporting systems and procedures, preparing will require a multi-disciplinary effort. Effective and timely FATCA preparation should start with a comprehensive impact assessment that identifies and assesses the following items, based on currently available guidance:

- tax implications on entities and business units;
- business issues affecting key functions and policyholder relationships;
- legal and compliance consequences on current and future contracts; and
- data and operational gaps across people, process and technology.

The time window to make relevant process and technology changes is closing. As companies seek to comply with increased due diligence, verification and reporting requirements for a larger base of customers, they will encounter significant technological and operational issues that may require substantial time and effort to overcome.

Initiating a programme now enables FFIs to respond strategically and also to reduce the impact on customers. Importantly, a wait-and-see approach may result in an inability to take on new customers come 2013.

The time to begin is now.

Mark Jansen
Partner
PwC Singapore
+65 6236 7388
mark.jansen@sg.pwc.com

Michael Brevetta
Associate Director
PwC Singapore
+65 6236 3801
michael.j.brevetta@sg.pwc.com

Contacts

Asia Leader

Peter Yu	peter.sh.yu@hk.pwc.com	+852 2289 3122

North Asia

China

Matthew Wong	matthew.mf.wong@cn.pwc.com	+86 21 2323 3052

Hong Kong

Peter Yu	peter.sh.yu@hk.pwc.com	+852 2289 3122
Jeremy Ngai	jeremy.cm.ngai@hk.pwc.com	+852 2289 5616
David Smith	david.g.smith@hk.pwc.com	+852 2289 5802

Japan

Sachihiko Fujimoto	sachihiko.fujimoto@jp.pwc.com	+81 3 5251 2423
Stuart Porter	stuart.porter@jp.pwc.com	+81 3 5251 2944

Korea

Han Chon	han-jun.chon@kr.pwc.com	+82 2 3781 3489

Taiwan

Richard Watanabe	richard.watanabe@tw.pwc.com	+886 2 2729 6704

South and Southeast Asia

India

Sunil Gidwani	sunil.gidwani@in.pwc.com	+91 22 6689 1177

Indonesia

Margie Margaret	margie.margaret@id.pwc.com	+62 21 528 90862

Malaysia

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

Philippines

Malou Lim	malou.p.lim@ph.pwc.com	+63 2 459 2016

Singapore

Paul Lau	paul.st.lau@sg.pwc.com	+65 6236 3733
Tan Tay Lek	tay.lek.tan@sg.pwc.com	+65 6236 3768

Pakistan

Soli R. Parakh	soli.r.parakh@pk.pwc.com	+92 21 3241 6434

Thailand

Ornjira Tangwongyodying	ornjira.tangwongyodying@th.pwc.com	+66 2 344 1118

Vietnam

Dinh Thi Quynh Van	dinh.quynh.van@vn.pwc.com	+84 4 39 46 22 31

Australasia

Australia

Matt Osmond	matt.osmond@au.pwc.com	+61 3 8603 5883
Gavin Marjoram	gavin.marjoram@au.pwc.com	+61 2 8266 0576

New Zealand

Mark Russell	mark.r.russell@nz.pwc.com	+64 9 355 8316

www.pwc.com