

Regional BCM Tax Round-Up

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Regional BCM Tax Round-Up Q4 2013

The Regional Banking and Capital Markets Tax Round-Up is a quarterly series which highlights recent developments and current hot topics affecting organisations across key regions, namely Australia, China, Hong Kong, India, Indonesia, Japan, Korea and Singapore.

This quarter the reform agenda is a common thread throughout the region, providing a platform of change in 2014.

Australia



Legislative reform and consultations

The recently elected Coalition Federal Government has announced its position in relation to a range of international tax measures that had been announced by the previous Labor Federal Government but not yet legislated. Of particular interest to financial services entities:

- i) The Government will proceed with previously announced changes to tighten the thin capitalisation regime which limits deductions available for interest (and other defined 'debt deductions') for certain 'inbound' and 'outbound' investors. Specifically, the Government will reduce the 'safe harbour' debt limit for non-bank financial entities from 20:1 to 15:1 on a debt to equity basis and increase the 'safe harbour' minimum capital for banks from four per cent to six per cent of the risk weighted assets of their Australian operations.

Want to know more? - <http://www.pwc.com.au/tax/taxtalk/assets/monthly/pdf/Thin-capitalisation-Dec13.pdf>

- ii) The Government announced that it would defer the October start date of intended **offshore banking unit** 'integrity' reforms until further consultation could be performed. The Government stated that '[c]onsultation on this measure has indicated that the reforms as announced could affect commercial transactions that should still be eligible for offshore banking unit treatment;'
- iii) The Government has deferred an earlier pledge to adopt a **tax on bank deposits** first announced by the former government in 2013. The issue will not form part of the Financial Services Inquiry (see below). If adopted, the plan may levy a 0.05 per cent charge on every bank deposit of up to \$250,000, which was forecast to generate approximately \$700m million in its first 18 months; and
- iv) In 2012 the Board of Taxation commenced a review on the tax arrangements applying to **permanent establishments**. Specifically, the Board of Taxation was asked to examine and report on the advantages and disadvantages of Australia adopting the functionally separate entity approach to the determination of the profits attributable to a permanent establishment in its tax treaty negotiations and in the domestic law. Further, there were a number of issues specific to the finance sector, including the application of the LIBOR cap to intra-entity borrowings. The Board has completed its review of tax arrangements applying to permanent establishments and provided its report to the Assistant Treasurer in April 2013. The Government is yet to release its response in respect of the report.

Beware: Reliance on Industry Tax Practice

On 3 September 2013, the Federal Court of Australia handed down a decision in response to Macquarie Bank Limited's (MBL) application for relief from the retrospective application of the Commissioner's views on a matter specific to the offshore banking unit (OBU) provisions, where that view was inconsistent with industry practice.

The implications of the case for taxpayers are two-fold. Firstly, at a technical level, it demonstrates a view by the Australian Taxation Office (ATO) that the use of management accounts to allocate expenses to an OBU of a taxpayer may not be reflective of the allowable OBU deductions as prescribed under the law. Consequently, taxpayers using management accounts as a basis of allocating expenses to the OBU should reconsider their position as it may be open to challenge by the ATO. Unfortunately the Court did not provide further guidance on the proper basis of allocation.

Secondly, relevant to taxpayers more generally, the case demonstrates the dangers of relying on "industry practice" and the ATO's "U-turn policy" (i.e., recanting on guidance) in Practice Statement Law Administration PSLA 2011/2. Indeed it shows that PSLAs and other forms of administrative guidance issued by the ATO cannot be relied on by taxpayers as they are not legally enforceable or binding on the Commissioner. This is a very unsatisfactory position for taxpayers and prompts an urgent need for a review of the ATO's administrative practices and the rights of taxpayers.

Industry reform

The Australian Government announced in November 2013 a Financial Sector Inquiry, which will issue an interim report in September 2014 and a final report in November 2014. The inquiry is charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth.

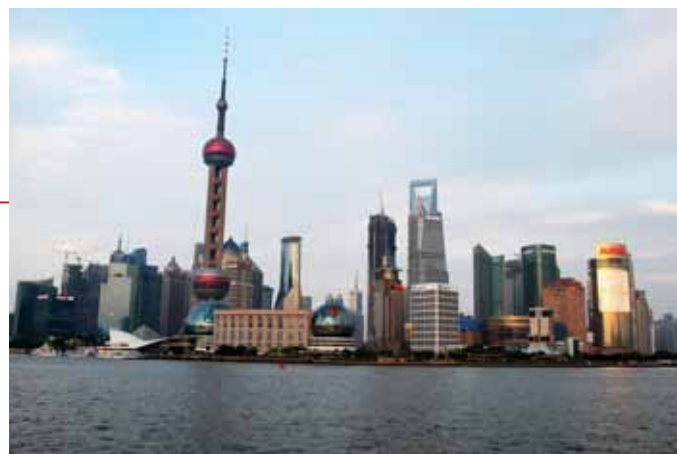
The terms of reference are broad in scope and reach across sectors and provides for only one significant exclusion (i.e. the conduct of monetary policy). There will be a focus on the funding of growth, competition, and overall quality of services to end-users.

Taxation issues are also flagged within the terms of reference. Specifically, the inquiry will examine:

- i) The taxation of financial arrangements;
- ii) Products or institutions, to the extent these impinge on the efficient and effective allocation of capital by the financial system.

Want to know more? – <http://www.treasury.gov.au/ConsultationsandReviews/>

China



State Administration of Taxation (“SAT”) has issued the circular Notice 63 for clarifying the Business Tax (“BT”) treatment for the trade of financial products.

Historically, the profit/losses from trading in financial products were divided into four baskets which are stocks, bonds, foreign exchange and other products, with the profit/loss of different products being available for offset each other provided the products were within the same basket and in the same tax filing period (i.e. within the same month).

In order to support and encourage the development of the financial industry, SAT has issued the circular Notice 63 for clarifying the BT treatment for the trade of financial products. In particular, Notice 63 clarified:

- i) Profit/losses from trading in financial products shall not be divided into four baskets (i.e., stocks, bonds, foreign exchange and other products), but shall be considered as one basket for BT purposes.
- ii) The profit/loss of different products is allowed to be offset with each other within the basket in the same tax filing period, and the net balance of that basket is the filing basis for BT purpose.
- iii) A negative balance of one tax filing period shall be carried forward to the next tax filing period, however, a year-end negative balance could not be carried forward to the next fiscal year.

The Notice took effect from 1 December 2013, replacing the previous rules with immediate effect.

China (Shanghai) Pilot Free Trade Zone

On 29 September 2013, the Chinese government formally established the China (Shanghai) Pilot Free Trade Zone (“SH PFTZ”) in Shanghai, China. How the area will affect businesses in China and throughout Asia is top of mind as multinational corporations and local Chinese companies seek to benefit from more relaxed financial and investment controls. As of mid-October 2013, 36 new companies had set up operations in the SH PFTZ in various sectors covering banking, leasing, logistics, e-commerce and trading.

The establishment of the SH PFTZ has been recognised as a crucial economic reform initiated by China’s new leadership. The ‘pilot experiment’ in Shanghai will include reforms focused on the following areas:

- i) Financial reform;
- ii) Upgrading of customs supervision framework;
- iii) Simplification of administrative systems supporting the further opening up of the services sector; and
- iv) Creation of a competitive regulatory and tax environment for businesses.

Hong Kong



Residence of an overseas bank with a Hong Kong branch

The Inland Revenue Department's latest view - Management or control of bank as a whole should be considered for determining residence of an overseas bank with a Hong Kong branch

In the past, the Inland Revenue Department's ("IRD") and the State Administration of Taxation of China ("SAT") had held different views on determining the residence of an overseas bank with a branch in Hong Kong. In Departmental Interpretation and Practice Notes ("DIPN") No. 44 (Revised) which provides guidance on the interpretation and application of the double tax arrangement ("DTA") between China and Hong Kong, the IRD took the view that if the Hong Kong branch of an overseas bank is managed in Hong Kong, the bank will be regarded as a resident of Hong Kong. However, the SAT has all along taken a view that the management or control of the bank, instead of that of the branch in Hong Kong, should be considered in deciding whether the overseas bank is "normally managed or controlled in Hong Kong".

In 2013 annual meeting between the IRD and the Hong Kong Institute of Certified Public Accountants, the IRD expressed its view and advised that a consensus has now been reached with the SAT. In deciding whether an overseas bank is "normally managed or controlled in Hong Kong", it has been agreed that the management or control of the bank as a whole should be considered. The relevant paragraph of DIPN No. 44 (Revised) will be updated accordingly.

Although DIPN No. 44 (Revised) is the IRD's interpretation of the Hong Kong-Mainland China DTA, it is expected that similar approach will be adopted for the other Hong Kong treaties. A confirmation from the IRD on this will be welcomed.

Taxability of unrealised profits

The Court of Final Appeal in Hong Kong handed down its judgment in the *Nice Cheer Investment Ltd. v CIR* on 12 November 2013, wherein it has held that unrealised revaluation profits recognised in the taxpayer's accounts prepared in accordance with the prevailing accounting standards are not taxable but unrealised revaluation losses of the taxpayer in this case are deductible. As a result of this judgment, it is likely that the Inland Revenue Department will have to change its current assessing practice of taxing unrealised profits from revaluation of trading securities.

Want to know more? - http://www.pwchk.com/home/eng/hktax_news_nov2013_13.html

India



Conversions/Establishment of wholly owned subsidiary by Foreign Banks in India

On 6 November 2013, the Reserve Bank of India (RBI) released the much awaited scheme for the conversion and establishment of wholly owned subsidiaries by foreign banks in India.

Key highlights of the scheme

- i) The scheme follows the cardinal principles of reciprocity and single mode of presence (i.e. a wholly owned subsidiary – WOS).
- ii) Foreign banks looking to set up a presence in India as well as foreign banks that have commenced business in India post August 2010 (and have also provided an undertaking to convert to a WOS if the RBI guidelines so require) will need to establish or convert into a WOS presence if any of the following conditions are met:
 - a. Banks incorporated in a jurisdiction with legislation giving a preferential claim to deposits of the home country in winding-up proceedings;
 - b. Banks without adequate disclosure requirements in their home jurisdiction;
 - c. Banks with complex structures;
 - d. Banks which are not widely held;
 - e. The RBI is not satisfied with the supervisory arrangements (including disclosure arrangements) and market discipline in the country of their incorporation;
 - f. If a foreign bank, which has set up its presence in India in branch mode after August 2010, is considered by the RBI as being systemically important by virtue of the size of its business;
 - g. Any other reason that the RBI considers that a subsidiary form of presence of the bank is necessary.
- iii) For foreign banks other than the above, having or aspiring to have a presence in India, conversion into a WOS or setting up a WOS shall be optional.
- iv) The scheme provides near national treatment and conditions similar to domestic banks under particular situations. Further, there are certain relaxations as compared to previously contemplated conditions, providing for greater flexibility in managing such a presence in India.

Income of foreign institutional investors from dealing in derivatives taxable as capital gains and not business income

In a recent ruling, the Mumbai bench of the Income Tax Appellate Tribunal (the Tribunal) held that income earned by a Foreign Institutional Investor (FII) from transactions in derivatives is in the nature of capital gains and not business profits.

Broadly, the FII claimed losses arising from index derivative trading transactions as short term capital losses and netted the losses against the capital gains earned on transactions in shares. The Assessing Officer held that the losses were business losses and came under the head of “income from business or profession” rather than under capital losses.

The Tribunal found in favour of the FII, sighting special provisions of the Income Tax Act which provide restrictions on an FIIs dealings in securities (i.e. investing versus trading) as well as governmental announcements in this regards. This makes for the third successive ruling from the Tribunal that the income of FIIs by way of transactions in derivatives is in the nature of capital gains. This is a welcomed confirmation of the application of the law.

Borrower’s credit analysis core to loan decision – Tribunal upholds profit attribution to PEs of banks

In a recent ruling in the case of M/s Credit Lyonnais, the Mumbai Bench of the Income-tax Appellate Tribunal (“the Tribunal”) held that the role played by the Indian bank branch in relation to credit analysis of Indian borrower are core to the overseas company branch for taking decisions on granting loans to the Indian borrowers. Accordingly, the Tribunal attributed 20% of the fee component received by the overseas company to the Indian bank branch for the credit analysis function. The Tribunal held that since the Indian bank branch had not contributed to the loan amount, (which was provided by the syndicate of banks outside India), interest income earned on the loan cannot be considered for attribution of income towards role played by the Indian bank branch.

Under Article 7(2) of India-France double tax agreement and Paragraph 4 of the Protocol between France and India, no profit can be attributed to a permanent establishment (PE) on account of facilitation of conclusion of foreign trade or loan agreements or the mere signing thereof. The Tribunal held that the role played by the Indian bank branch would not fall under such exception, and that the credit analysis performed by the Indian bank branch was core to taking decisions on granting the loan. Accordingly, the Tribunal held that a part of fee income charged by overseas company can be attributable to Indian bank branch.

Indonesia



Legislative reform and focus areas for the Directorate General of Taxes (DGT) Base Erosion and Profit Shifting (BEPS)

In a recent public forum, officials from the DGT highlighted the action plans that will be rolled out with regard to BEPS, including:

- Strengthen the Anti-Avoidance Rule (“AAR”) by updating the regulation on Controlled Foreign Corporation (“CFC”) and proposing to include the AAR provision into the Income Tax Law;
- Revise and strengthen Transfer Pricing rules and regulations;
- Enhance the Mutual Agreement Procedure (MAP) and the Advanced Pricing Agreement (APA) processes;
- Increase tax transparency by entering into Exchange of Information (“EOI”) agreements and Improve tax cooperation agreements.

As yet, there has been no indication of the time frame for implementation of these action plans, however this signifies the commitment of the DGT to such reform.

Circular on Transfer Pricing Audits

The DGT recently issued a new Circular No.SE-50/PJ/2013 (“SE-50” or the “Circular”) effective 24 October 2013, to provide technical guidelines on transfer pricing audits. The guidelines set out in the Circular are applicable for special or routine tax audits for taxpayers with the following criteria:

- a. Those who have been identified as carrying risk of tax avoidance using transfer pricing means, before a tax audit notification letter (“SP2”) has been issued; or
- b. Those who have been identified as carrying risk of tax avoidance using transfer pricing means, during an ongoing tax audit where the assigned tax audit team may revise its audit plan and program accordingly.

There are many areas of focus in the SE-50, however what is clear are the benefits of contemporaneous documentation, especially for taxpayers who fall in the tax avoidance risk profile. Robust transfer pricing documentation will help minimise tax auditor’s queries and detailed questionnaires during audit and help manage the timeframes for resolution.

Final Tax on Bonds at the rate of 15% will be postponed to 2020

A government regulation in respect of the postponement of the increase in withholding tax rate (from 5% to 15%) on bonds received by mutual fund until 2020 has been drafted and it is now under review by the Ministry of Law and Human Rights. The final regulation is expected to be issued by the end of 2013. This is a welcomed outcome for the bond market.

Recent favourable tax court decisions

Loan write-offs - as part of the tax requirement to claim a loan write-off, the DGT required the taxpayer to provide the tax ID number (“NPWP”) of the debtors, including individuals on the list of bad debt write-offs. The DGT disallowed the write-off where the taxpayer could not satisfy this requirement. However, on appeal to the tax court, the taxpayer was issued a favourable decision, and a deduction was permitted.

Non-Deductibility of Head Office Administration Expenses (“HOAE”) for the branch - The tax court decided that HOAE were deductible for the branch based on the following key facts:

- The HOAE supported the business activity and provided benefit for the branch in generating taxable income in Indonesia
- The HOAE were allocated accurately and had been certified by an independent public accountant.

Industry reform

Merger of Banks Proposal by Indonesian Central Bank (“BI”)

In a meeting between the BI and the DGT, the BI highlighted the proposal of bank mergers in anticipation of the Asean Economic Community roll out in 2015. The BI proposed to limit the numbers of Banks operating in Indonesia. Out of 120 existing banks, it was proposed to limit the number to between 20 and 30, with the expectation of mergers of smaller banks.

While taxation is only one consideration in a bank merger, a tax working team will be established to consider how to formulate a strategic approach to updating the existing tax regulations to support such a rationalisation of the banking industry.

Japan



The first half of 2013 has been a period of tax reform for Japan, and the second half of the year was no exception. Recent announced or enacted tax reform:

Changes to the taxation of financial instruments

The 2013 tax reforms legislated earlier this year included changes to the taxation of financial instruments for individuals and foreign corporations. The objective is to move to a unified system of the taxation of financial instruments, resulting in significant change to current treatment. Key reforms include:

- i) taxation of bonds and discount bonds;
- ii) withholding tax exemption for qualified entities; and
- iii) withholding tax exemptions and reforms for corporations.

Other reforms include the expiration of concessionary tax rates for dividends and capital gains on listed shares as well as the simplification of treaty application procedures. The above reforms will be of particular relevance to the customers of financial institutions investing into or operating within Japan.

Want to know more? - <http://www.pwc.com/jp/en/taxnews-financial-services/assets/2013-tax-reforms-financial-instruments-en.pdf>

Investment incentives

With details to follow, the Tax Reform Proposal set out a number of investment incentive, with the key proposals being:

- i) Amendments to R&D tax incentive - the amendment will see the extension of the applicable period for credits by three years. Further, where certain requirements are satisfied, up to 30% of the incremental R&D cost will be allowed as a credit (currently 5%).
- ii) New incentive for venture capital investment - along with the accreditation of venture capital partnerships, investment tax incentives will be introduced to allow corporate investors the ability to take a loss from a venture capital investment on an accelerated basis.

Want to know more? - <http://www.pwc.com/jp/en/taxnews/pdf/consumption-tax-e.pdf>

Future reforms to monitor

Report of the introduction of attribution rule to the taxation of permanent establishments

The Ministry of Finance released its report on the Taxation of Permanent Establishments on 24 October 2013, in response to the OECD Report on the Attribution of Profits to Permanent Establishments. For Japan this would mean the shift from the current entire method to that of the attribution method. Were Japan to adopt the changes to be in line with the principles as applied by the new Article 7, the attributable income of a PE would be calculated based on the functional and factual analysis of the PE as if the PE were a separate and independent enterprise, by:

- i) allocating assets, risks and capital to the PE;
- ii) recognising intra-entity dealings; and
- iii) hypothesising dealings.

The impact that flow from the reforms that would be necessary to adhere to the revised Model Tax Convention includes:

- i) revision of the definition of domestic source income and recognition thereof;
- ii) timing and recognition of intra-entity and hypothesised dealings;
- iii) cost allocation approaches;
- iv) documentation requirements to support nature and pricing of intra-entity dealings;
- v) Capital allocation and interest deduction limitation.

Finally, to manage the potential for double taxation, the proposed reforms would also include the introduction of foreign tax credit regime for foreign corporations with a PE in Japan in order to alleviate an unfair tax burden.

Want to know more? - <http://www.pwc.com/jp/en/taxnews/pdf/jtu94-aoa-e.pdf>

Korea



Proposed expansion of Overseas Investment Vehicle (OIV) regime to tax exemption claims under a treaty

From 1 July 2012, non-residents wishing to claim a reduced rate under a treaty in respect of Korean sourced income are required to file an application to the Korean withholding agent.

Where the non-resident is an overseas investment vehicle (“OIV”), which is a reference to any type of collective investment vehicle, the OIV is required to claim the reduced treaty rate based on the treaty profile of the underlying investors rather than the OIV itself. Thus, a “blended” rate based on the treaty profile of the underlying investors is used in claiming the treaty benefit by an OIV.

Such “look-through” approach to claiming treaty benefits under the OIV regime is currently limited to reduced treaty rate claims and does not apply to tax exemption claims under a treaty as in the case of capital gains which is generally tax exempt under many of the treaties entered into by Korea.

It is proposed to extend the “look-through” approach under the OIV regime to tax exemption claims under the treaty from 1 January 2014.

Proposed taxation on listed derivatives

Under the Korean tax law, neither the income tax nor transaction tax is imposed on trading of listed derivatives.

In 2012, the government submitted a proposal to impose the securities transaction tax on the futures and options to the National Assembly. However, the proposal was not passed.

Currently a proposal has been put forward to the National Assembly to impose income tax on gains from trading of listed derivatives. It is expected the National Assembly will come to a decision prior to the end of 2013.

Singapore



Research and development tax measures

The Inland Revenue Authority of Singapore (IRAS) revised its circular on the research and development (R&D) tax measures. With effect from 6 November 2013, the requirement to submit R&D project details with the tax return has been removed. Taxpayers are, however, still required to maintain detailed project descriptions and provide them to the IRAS upon request.

Taxation of employer-provided accommodation

On 12 November 2013, the IRAS issued guidance on the changes to the taxation of employer provided accommodation benefits that was announced in the 2013 Budget Speech. These changes are intended to make the taxation of housing benefits simpler and fairer, and will take effect from 1 January 2014.

Legislation updates

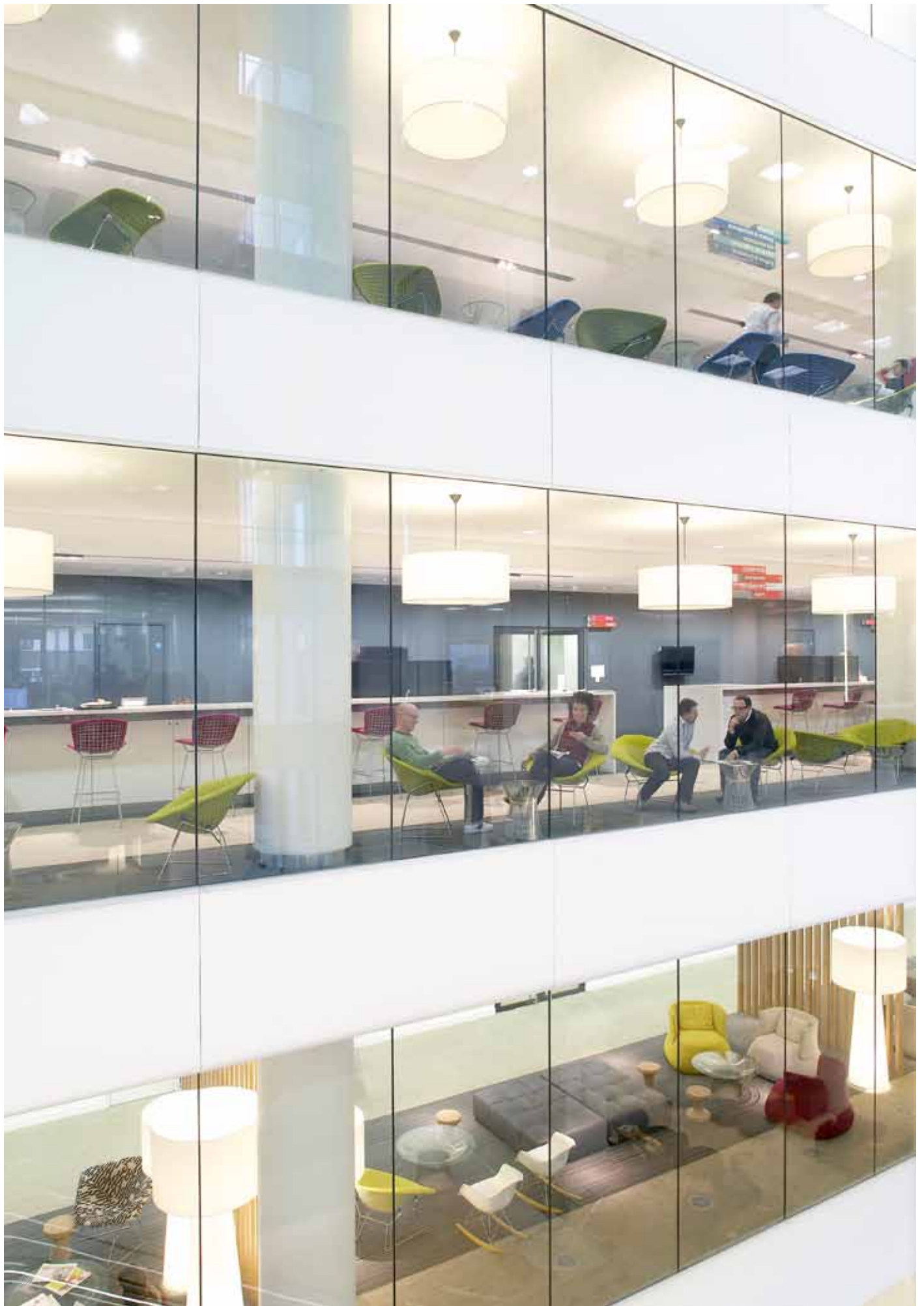
Subsidiary legislation which provides for the following changes to the tax incentives for fund management:

- i) Approved persons under sections 13R and 13X of the Income Tax Act to be allowed to make changes to their investment strategies with effect from 8 October 2012, subject to approval.
- ii) Removal of the financial penalty for section 13X funds holding less than 100% of a section 13CA fund or section 13R fund.
- iii) Removal from the definition of an “associate”, for the purposes of sections 13CA and 13R, an approved person under section 13X which beneficially owns directly any of the issued securities of the section 13CA fund and section 13R fund.

Singapore tax cases

Exchange of information - The High Court cases of *Comptroller of Income Tax v BKW & Anor* (2013) MSTC 70-026 and *Comptroller of Income Tax v BLM* [2013] SGHC 212 dealt with applications to set aside court orders made under section 105J of the Income Tax Act for disclosure of bank information. The orders were made pursuant to the tax treaties with India and Japan respectively. Both applications were dismissed.

It should be noted that the requirement for IRAS to seek a court order to obtain customer information from banks and trust companies has since been removed.



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