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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.

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Contents

Foreword

Because banks operate in a highly regulated environment, their tax positions are often significantly impacted by regulatory developments. Following the recent global financial crisis, the Basel Committee on Banking Supervision released a package of measures (commonly known as the Basel III requirements) that aims to further strengthen the capital and liquidity position of banks. The lead article of this issue examines specifically the liquidity requirements of these measures, and explores the tax implications of such measures for global banks. In particular, it considers the tax and transfer pricing implications of liquidity reserve expense for banks operating in Australia, Hong Kong, Japan and Singapore.

Transfer pricing remains a common theme in the Asia Pacific tax landscape, whether it is the reform of the rules in Australia, introduction of advance pricing arrangement in Hong Kong, continuing scrutiny of support charges to foreign banks operating in China or the revision of regulations in Indonesia (as reported in the respective country articles). In part, this reflects the increasing sophistication of the tax authorities in the region. But it also reflects the development of Asia with the increased cross-border flows of trade and services.

Against a backdrop of increasing cross-border investment flows, the proposed introduction of retroactive application of indirect transfer taxation in India will no doubt serve to remind foreign investors that the promise of high returns in emerging markets often comes with risks.

Whether they are global developments such as the Basel III requirements or country-specific measures such as the drive for local incorporation (for example, in China and India), it is clear that bank tax directors will need to have a clear understanding of the impact of regulatory changes on the bank's business in addition to keeping abreast of country tax developments in order that they can effectively manage the bank's tax affairs.

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Peter Yu
Asia Financial Services
Tax Leader

Paul Lau
Co-editor
BCM Tax

David Smith
Co-editor
BCM Tax

Lead Article

Liquidity requirements: tax implications for global banks

The reverberations from the global financial crisis continue to be felt in the financial services sector, particularly among global banks. From a *regulatory* standpoint, there is increased pressure on banks to maintain adequate capital and liquidity reserves. This trend, which is reflected in the requirements of national bank regulators and the Basel III requirements, imposes additional, often significant, funding costs on banks. From a *tax* standpoint, many governments are under increasing budgetary pressure and are strengthening enforcement of their tax laws, particularly with respect to transfer pricing and to the deductibility of expenses such as interest. Global banks, with their large number of cross-border transactions and status as major taxpayers in many jurisdictions, will clearly be affected by this trend. At the intersection of these regulatory and tax trends is the tax treatment of a bank's liquidity reserve expense.

Liquidity reserve requirements

Banks typically maintain "liquidity reserves". These are portfolios of high-quality, liquid assets such as cash and US Treasury bills that can be sold quickly (and without a significant decline in value) during a severe liquidity crisis to provide cash to meet the bank's payment obligations. Banks maintain liquidity reserves as part of their balance sheet management and to meet regulatory requirements. Basel III contains a specific liquidity reserve requirement in its "liquidity coverage ratio," which essentially requires a bank to maintain sufficient high-quality, liquid assets to cover net cash outflows during a 30-day period of severe stress (when net cash outflows are likely to be considerably higher than normal).

Liquidity reserve requirements are in addition to requirements relating to bank capital and other sources of stable funding, which address the bank's ability to meet its obligations over a longer period under circumstances of less severe financial stress.

The computation of liquidity reserves can be complex and bank-specific. However, it is worth providing a brief summary of some of the considerations that go into calculating the amount of a liquidity reserve with a view to understanding its treatment from a tax perspective. Liquidity reserve requirements address both what *type* of high-quality liquid assets must be held in the reserve and the *amount* of such assets required. As noted, the amount is derived from expected net cash outflows during a severe financial crisis lasting at least 30 days. Determining these net cash outflows requires modeling how financial crisis stress is expected to affect the behaviour of the bank's counterparties and creditors, potentially causing them to withdraw funding more quickly than normal. For example, providers of short-term funding to the bank might refuse to provide new funding or roll over existing funding, and depositors may withdraw assets. At the same time as the bank's short-term funding sources are reduced, the bank's own customers may make greater demands on the bank to provide funding by drawing down credit lines and facilities, thus exacerbating the bank's need for liquidity. Liquidity reserve models typically consider the amount of liabilities and commitments of different types that a bank has; they make assumptions about the percentage of each type of liability or commitment that will be withdrawn or not renewed and require that the liquidity reserve be sufficiently large to cover this.

Global banks, with their large number of cross-border transactions and status as major taxpayers in many jurisdictions, will clearly be affected by this trend. At the intersection of these regulatory and tax trends is the tax treatment of a bank's liquidity reserve expense.

One of the key challenges in obtaining a deduction for liquidity reserve expense in all the countries that potentially benefit from the reserve is to clearly demonstrate and document the factual relationship between the expense and the bank's business in the country.

Tax issues relating to liquidity reserves

Tax issues arise with respect to liquidity reserves for two main reasons. First, the liquidity reserve usually results in a significant net interest expense to the bank because the interest paid on the funding used to acquire the liquidity reserve assets is typically higher than the interest earned on the assets themselves. This is due to both credit spreads (the bank's cost of borrowing typically being higher than the cost of borrowing of the sovereign whose debt is held in the liquidity reserve) and the fact that the bank's funding is typically longer-term. The bank will seek to deduct this expense in the countries in which it does business.

Second, the liquidity reserve may be managed and maintained centrally or in a limited number of major financial centres, and the amount of the liquidity reserve is typically determined on a global basis by the bank's treasury department. From a tax perspective, the pertinent question is thus the nexus between the liquidity reserve and the bank's business in a particular country.

Deductibility of liquidity reserve expense

One of the key challenges in obtaining a deduction for liquidity reserve expense in all the countries that potentially benefit from the reserve is to clearly demonstrate and document the factual relationship between the expense and the bank's business in the country. This is particularly important where the liquidity reserve is managed and maintained outside the country, and the bank's business in the country has not actually drawn funding from the liquidity reserve (e.g. because there has not been a global liquidity crisis of sufficient magnitude). It is important for tax authorities to be aware that, although the liquidity reserve may be managed and maintained centrally for various reasons, e.g. efficiency and personnel management, the liquidity reserve provides an important benefit to *all* bank locations requiring funding: Inability of the bank to obtain sufficient funding during a liquidity crisis could result in the bank's failure, thus preventing it from earning future income in the country (which would be subject to taxation).

A second hurdle in obtaining a deduction for liquidity reserve expense is to determine the nature of the expense and then fit it within an established category of deductible expense. This can present challenges where, for example, where the interest is not viewed as immediately funding assets held by a business in the country.

Where, due to the specific requirements of the tax law in a particular country, an interest deduction cannot be obtained with respect to liquidity reserve expense, consideration should be given to claiming a deduction on another basis. For example, certain types of general corporate expenses may be deductible as head office expenses or other management expenses.

Transfer pricing issues relating to liquidity reserve expense

Assuming central liquidity reserve expense is deductible in a country, it may be necessary to establish that the amount of expense claimed in that country meets the country's transfer-pricing requirements. The central liquidity reserve is the aggregate reserve needed taking into account the bank's business operations and assets requiring funding in all locations. Thus, the portion of the liquidity reserve relating to the assets of the bank's business in each location should provide the amount of the liquidity reserve relating to that location.

Ideally, a bank's existing information technology systems will be able to track businesses and assets by location, or can be modified to do so.

Related tax issues

The countries in which a global bank operates may have local liquidity reserve requirements, which may supersede, be subsumed by, or operate in conjunction with the liquidity reserve requirements of the bank's home-country regulators. In cases where a bank's global liquidity reserve requirements supersede local requirements, tax authorities may raise questions where the global requirements are greater than the local requirements. Where a bank is required to maintain some liquidity reserves locally, these should be taken into account when allocating global liquidity reserve expense to the location.

More generally, deduction of liquidity reserve expense is one of a number of tax issues that arise in connection with a bank's deduction of interest expense. These issues include the appropriate tenor and interest rate for internal (intrabranch and with subsidiaries) funding. It is often desirable for a global bank to consider these issues together in order to develop a consistent global approach that addresses all aspects of the bank's interest deduction expenses in a way most likely to be acceptable to the tax authorities of the countries in which it operates.

Discussion of tax treatment of liquidity reserve in Asia Pacific countries

Singapore

Deductibility of liquidity reserve expense

The treatment of liquidity reserve expense for Singapore tax purposes has not been specifically addressed. The better view is that a deduction for an appropriate amount of liquidity reserve expense should be allowed and that any inquiry by the Singapore tax authorities should focus on the amount properly deductible under transfer-pricing principles. The technical issues affecting the deductibility of liquidity reserve expense that arise under Singapore tax law in certain factual situations, as well as transfer-pricing considerations, are discussed below.

1. Deduction of liquidity reserve expenses by a Singapore branch

The Singapore tax law pertaining to deductibility of interest and other expense, section 14(1) of the Income Tax Act, provides:

> *for the purpose of ascertaining the income of any person for any period from any sources chargeable with tax under this Act, there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of the income, including –*

More generally, deduction of liquidity reserve expense is one of a number of tax issues that arise in connection with a bank's deduction of interest expense.

(a) except as provided in this section –

(i) any sum payable by way of interest; and

(ii) any sum payable in lieu of interest or for the reduction thereof, as may be prescribed by regulations…

Liquidity reserve expense comprises primarily net interest expense (the difference between the amount earned on the assets that form the liquidity reserve and the interest paid on the borrowings used to finance acquisition of those assets). This should fall within the deduction allowed by section 14(1) for interest provided the connection between liquidity reserve expense and the business of the branch in Singapore is established and appropriately documented, and the expense is appropriately reflected in the branches' accounts. In terms of the specific language of section 14(1), liquidity reserve expense should be viewed as incurred "in the production of income" because the branch would be unable to hold certain types of income-producing assets if a liquidity reserve were not maintained (due to regulatory requirements and the risk of large losses from a forced sale of the assets during a liquidity).

For Singapore tax purposes, liquidity reserve expense incurred by a branch should be viewed as incurred "in the production of income" because the branch would be unable to hold certain types of income-producing assets if a liquidity reserve were not maintained.

Further support for a deduction can be found in the opinion of the Singapore Court of Appeals in *Pinetree Resort Pte Ltd v. Comptroller of Income Tax,* [2000] 3 SLR(R) 136, 47, which stated that "in determining whether the nexus [between the incurrence of expense and production of income in section 14(1)] is present, the business has to be looked at as a whole set of operations directed toward producing income, in which case an expenditure which is not capital expenditure is usually considered as having been incurred in gaining or producing income." This language appears to create a presumption that a non-capital expense of a business is directed towards the production of income.

The case for deductibility of liquidity reserve expense under section 14(1) is strengthened where there is a double taxation treaty between Singapore and the bank's country of residence (which will typically be the case, except for US banks). Article 7 (Business Profits) of the OECD Model Tax Convention, which forms the basis for Singapore tax treaties, provides that the profits of a permanent establishment (branch) may be taxed in Singapore and are to be computed based on the profits that the Singapore permanent establishment (PE) –

might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

Banks throughout the world maintain liquidity reserves for both regulatory reasons and to prudently manage their balance sheet risks. A bank's liquidity reserve amount is based on the assets and activities of its various branches and subsidiaries. Thus, where the Singapore branch conducts the type of activities, has the type of assets, and assumes the type of liquidity risks that require a liquidity reserve, the business profits article in the treaty should support a deduction for an appropriate amount of liquidity reserve expense.

It should be noted that liquidity reserve expense may include a component of gain or loss resulting from, for example, sale of liquidity reserve assets before maturity at a price different than cost. These amounts are likely to be relatively small compared to the net interest expense from the liquidity reserve and, unlike the net interest expense, may result in positive or negative profit and loss impact. Such gain or loss should be assessable or deductible as income or losses arising from ordinary banking activities.

2. Deduction of liquidity reserve expenses by a Singapore subsidiary

From a tax policy and fairness viewpoint, a branch and subsidiary of a bank should be treated similarly for tax purposes if they conduct the same business. (The business profits article in treaties specifically provides that a branch should be treated as if it were a separate entity.) However, the technical requirements for obtaining a deduction may differ in each case.

The technical challenge in the case of the subsidiary is that the subsidiary is not, as an entity, the obligor with respect to the borrowings that give rise to liquidity reserve expense. (In the case of a branch, the legal entity of which the branch forms a part is the obligor with respect to the borrowings even though the branch itself may not be.)

As noted previously, section 14(1) provides that "there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period *by that person* in the production of the income" (italics supplied). Thus, the person claiming the deduction must be the person incurring the expense, which is not the case if a subsidiary claims a deduction for liquidity reserve expense incurred by its parent.

While it might be difficult for a Singapore subsidiary to *directly* claim a deduction for liquidity reserve expense under section 14(1) if it is not the entity paying the interest and incurring the expense, it should be possible to obtain a deduction where the Singapore subsidiary receives a *separate* charge from its parent for its share of liquidity reserve expense, and such charge is reflected in the financial accounts of the subsidiary. This is commonly done for other types of global or group-wide expenses that are incurred at the head office level and benefit a subsidiary. The guiding principle is that, where the liquidity reserve expenses can be shown to benefit the subsidiary and are reasonable in amount, a deduction should be allowed to clearly reflect the profit and loss of the subsidiary under generally-accepted tax and accounting principles and to prevent double taxation. This result is consistent with the approach taken by the Singapore Court of Appeal in *Pinetree*, which stated that, in determining the deductibility of an expense under section 14(1), "a holistic view that eschews artificiality and technicality ought to prevail."

Transfer-pricing considerations

The most difficult tax issue, from the viewpoint of both banks and tax authorities, is likely to arise in the context of transfer pricing. While no explicit guidance has been provided by the Singapore tax authorities with respect to liquidity reserve expenses, general guidance on transfer pricing matters by the Singapore tax authorities can be used to formulate a number of guidelines that are likely to increase the likelihood of obtaining a full deduction of liquidity reserve expenses.

There may be a technical challenge for a Singapore subsidiary to claim a direct deduction for liquidity reserve expense if it is not the entity paying the interest and incurring the expense.

An appropriate transfer-pricing method for allocating liquidity reserve expenses will depend on a bank's particular circumstances, including how it calculates its liquidity reserve and the data available for allocating the reserve among branches and subsidiaries.

1. Singapore transfer-pricing rules

The statutory basis for Singapore's transfer pricing requirement is found in section 34D of the Income Tax Act, which provides that

> *[W]here 2 persons are related parties and conditions are made or imposed between the 2 persons in their commercial or financial relations which differ from those which would be made if they were not related parties, then any profits which would, but for those conditions, have accrued to one of the persons, and, by reason of those conditions, have not so accrued, may be included in the profits of that person and taxed in accordance with the provisions of this Act.*

This language is also found in Article 9(1) of the OECD Model Tax Convention and in Singapore tax treaties. In addition, as noted above, Article 7(2) of the OECD Model Tax Convention and Singapore tax treaties provide that, in determining the profits of a PE, the PE should be considered "a distinct and separate enterprise engaged in the same or similar activities and under the same or similar conditions." This implies that the same transfer-pricing considerations should apply to both a branch and a subsidiary.

The Inland Revenue Authority of Singapore (IRAS) has published a useful circular containing transfer pricing guidelines. The circular sets out a number of guiding principles, which include (to choose those most relevant to transfer pricing of liquidity reserve expense):

- Transfer pricing is not an exact science and requires the exercise of judgement. Taxpayers are therefore recommended to adopt a pragmatic approach.
- Certain business structures and arrangements are complicated and unique, and are rarely encountered between independent parties.
- Establishing an arm's length price will sometimes require substantial analysis of large volumes of data information, which may not be readily available, and it may be costly for taxpayers to perform comprehensive analyses to establish and document an arm's length price.
- Taxpayers know their businesses and circumstances best, which puts them in the best position to perform robust and comprehensive transfer pricing analysis to determine an arm's length price.
- When a taxpayer has exercised reasonable efforts to ensure its pricing is arm's length, the transfer pricing will be considered to be prima facie arm's length.

The guidance set out in the circular, and our experience dealing with the IRAS, suggests that they will be flexible when considering an appropriate method for allocating liquidity reserve expense and are likely to look favourably on a well-designed and well-documented method.

2. Guidelines for transfer pricing of liquidity reserves

An appropriate transfer-pricing method for allocating liquidity reserve expenses will depend on a bank's particular circumstances, including how it calculates its liquidity reserve and the data available for allocating the reserve among branches and subsidiaries. Thus, it is not possible to give specific guidance for determining a transfer-pricing method without considering a bank's particular situation. However, it is possible to provide some general guidelines based on our own experience and in keeping with the principles and practice of the IRAS.

- Consider in the first instance the method used by the bank to calculate its overall liquidity reserves and whether this method can be used to allocate liquidity reserves to branches and subsidiaries based on their assets and funding needs. Liquidity reserve computations are often complex and generally use large amounts of data, so it is preferable to “piggy back” on existing work done by the bank rather than having this done by the tax department, which can consume significant resources and possibly increase operational risk. Technical considerations in connection with this are set out in the following section.

- Where the bank’s method for calculating liquidity reserve on a global basis cannot be applied to allocate liquidity reserve to individual branches and subsidiaries (e.g. due to limitations in information technology systems or data), ensure that the treasury department or other relevant group within the bank is fully committed to providing and reviewing data needed to perform the calculations, and that it can also provide comments about the reasonableness of the transfer-pricing method from a business perspective.

- Aim for an allocation that is most likely to satisfy tax authorities (and, where relevant, regulators) in the locations to which the bulk of liquidity reserve expense is expected to be allocated.

- Apply the chosen method consistently to all locations by charging and deducting the expense unless specific regulatory or tax rules in the location prevent it from doing so.

- Document the allocation method with an explanation of the basis for the method and how it is calculated. It is often helpful to include a non-technical summary of underlying principles and key points (with diagrams if appropriate) and a simplified calculation so that the tax authorities clearly understand the reasoning behind the method and the basis for the calculation.

- Consider executing an agreement among the relevant locations with respect to the liquidity reserve. The agreement might include the rationale for maintaining the liquidity reserve, the benefits that accrue to locations being charged liquidity reserve expenses, and the right of the location to access the liquidity reserve. The agreement may be multilateral or a series of bilateral agreements with the entity that maintains the liquidity reserve. While an agreement between a branch and its head office may not have legal effect, it may nonetheless be useful in some cases to execute agreements with branches as well as subsidiaries.

3. Technical considerations relating to liquidity reserves

In principle, the global liquidity reserve is the sum of the liquidity reserves required for all the bank’s branches and subsidiaries. It should, therefore, be possible to “deconstruct” or back out the portion of the liquidity reserve relating to the Singapore branch or subsidiary through the formula used for computing the amount of the global liquidity reserve. Unfortunately, this may be difficult to do for both practical and theoretical reasons. The practical reason is that the bank’s information technology systems would need to have the data analysed by location and be set up to

After establishing the transfer pricing method, the bank should apply the chosen method consistently to all locations by charging and deducting the expense unless specific regulatory or tax rules in the location prevent it from doing so.

An Australia branch / subsidiary should generally be able to claim a deduction for an appropriate amount of liquidity reserve expenses in computing its taxable profits.

make the necessary calculations (which may need to be done for non-tax purposes).

The theoretical reason is complex. As noted in the introduction, the liquidity reserve amount will depend on the stability of the sources of funding as well as the type of assets requiring funding. There are thus two components or variables in the liquidity reserve calculation, one relating to assets and the other relating to liabilities. Because liabilities may be incurred *centrally* rather than *locally*, there is a complex interplay between the two factors, which may impact different locations differently, that must be considered in determining how to allocate liquidity reserve expense to each. This problem will be reduced in practice to the extent assets are funded locally and, if they are not, any internal funding takes into account the type of asset being funded and/or reflects the bank's actual external funding.

In some cases, a branch or subsidiary may be required to hold its own local liquidity reserve independently of (or to supplement) the global liquidity reserve. The cost of maintaining a local liquidity reserve should be taken into account in determining an allocation of global liquidity reserve expense.

The liquidity reserve is one element of the funding cost of a bank's branches and subsidiaries. Ideally, all funding elements should be taken into account to ensure that the overall funding to a bank's branches and subsidiaries is at arm's length. Long-term funding, in particular will have an impact on liquidity reserve allocation because the stability or "stickiness" of funding is a component of the liquidity reserve. Thus, the extent to which a branch or subsidiary has long-term funding (either external or internal) will affect the amount of liquidity reserve it requires.

Australia

Deductibility of liquidity reserve expense

1. Deduction of liquidity reserve expenses by an Australian branch.

Essentially, under Australian tax law a loss or outgoing (including a loss made in respect of a financial arrangement) is deductible to the extent that it is incurred in gaining or producing Australian assessable income or is necessarily incurred in carrying on a business for the purpose of gaining or producing Australian assessable income.

The Australian branch is not a separate legal entity from head office or other branches. In this context, deductibility of liquidity reserve expense arises on the basis of attributing relevant losses/outgoings to income derived in Australia (rather than recognising any form of internal charge between head office/other branches to the Australian branch).

Because, essentially, a portion of the liquidity reserve expense is incurred in supporting the holding of associated illiquid assets of the Australian branch (and in respect of which the Australian branch derives Australian assessable income), the appropriate portion of the liquidity reserve expense should be deductible in Australia in computing the taxable profits of the Australian branch.

This outcome is supported by the operation of relevant double taxation treaties between Australia and other jurisdictions, where relevant.

2. Deduction of liquidity reserve expenses by an Australian subsidiary.

   In the case of a subsidiary, relevant liquidity reserve expense is likely to be reflected in the form of a charge from head office or other group entity which holds the liquidity book.

On the basis that this charge is incurred in gaining or producing Australia assessable income or is necessarily incurred in carrying on a business for the purpose of gaining or producing Australian assessable income, the charge should be deductible in computing the taxable profits of the Australian subsidiary.

Transfer-pricing considerations

1. Australian transfer-pricing rules

Australia's domestic law dealing with transfer pricing is contained in Division 13 of Part III of the Income Tax Assessment Act 1936 (ITAA) (sections 136AA to 136AF). The domestic transfer pricing legislation is supplemented by the applicable provisions in Australia's double tax agreements (DTAs), in particular the associated enterprises and business profits articles.

The Australian Taxation Office (ATO) has traditionally held the view that the relevant DTA Articles also give the ATO the ability to impose tax (in addition to relieve double taxation) and has recently introduced in the Parliament a Bill to retrospectively amend Australia's transfer pricing rules. The Bill confirms the intent of the Government to introduce legislation that would allow the Commissioner to issue transfer pricing assessments under the Associated Enterprises or Business Profits Articles of Australia's Double Tax Agreements. This power will be in addition to the Commissioner's existing ability to raise transfer pricing assessments under Division 13 of the Income Tax Assessment Act.

In addition to the statutory rules referred to above, the ATO has issued various public rulings concerning transfer pricing. These both interpret the application of the statutory rules and provide guidance on other issues not specifically covered by the statute.

Rulings applicable to transfer pricing for liquidity reserves include:

- Branch funding for multinational banks – *Taxation Ruling 2005/11*
- Permanent establishments (PEs) – *Taxation Ruling 2001/11*
- Intra-group services – *Taxation Ruling 1999/1*

In *TR 2005/11*, the ATO recognises 'internal loans' for purposes of allocating profits to PEs of banks in respect of internal funds transfers where it is not possible to trace the external source and end use of the third party borrowed funds. In July 2011, the ATO released a paper on profit allocation to PEs of banks clarifying that this "separate entity approach" does not extend to other internally recorded financial dealings. It is important to note that Australia has not adopted the new text of Article 7 into any of its DTAs nor has it adopted the Authorised OECD Approach outlined in the 2010 Permanent Establishment Attribution paper. The Government has commissioned the Board of Taxation to investigate the impact of Australia adopting the Authorised OECD Approach in respect of the attribution of profits to PEs. The Board has also been asked to review the current LIBOR cap rule which applies to foreign bank branches in Australia. The Board will report to the Government by April 2013. The uncertainty surrounding this issue, adds an additional level of complexity with respect to the transfer pricing treatment of liquidity reserve expenses to branches.

2. Guidelines for transfer pricing of liquidity reserve expenses

To date there has been no specific guidance from the ATO with respect to

A recent Bill has been introduced to allow the Commissioner to issue transfer pricing assessments under the Associated Enterprises or Business Profits Articles of Australia's DTAs.

Although the methodologies involved in applying Australia's transfer pricing rules to international dealings between separate legal entities are similar to those for dealings between a branch and its head office, there are differences between the taxation principles applicable to PEs and subsidiaries that may produce different outcomes among the two settings.

attributing liquidity reserve expenses. Accordingly, we consider the application of the transfer pricing rules based on the general guidance issued by the ATO outlined above.

If it is established that a portion of the liquidity reserve expense is incurred in support of assets held within an Australian branch and is deductible, and the 'actual' cost of carrying the additional liquidity can be reliably identified, the relevant transfer pricing consideration is how to allocate the liquidity reserve expense between the head office and the Australian branch.

A working paper published by the Australian Prudential Regulation Authority (APRA) in March 2011 suggests that the liquidity reserve charge to business activities creating the need for banks to carry additional liquidity should be based on their predicted, or expected, usage of contingent liquidity during significant liquidity stress scenarios (i.e. expected benefit).[1]

In practice, the ability to charge the liquidity reserve expense to branches and subsidiaries on a predicted usage basis will depend on the bank's internal systems for measuring contingent liquidity risk on a granular basis.

Where the bank's systems do not facilitate the measurement of predicted usage at the branch or subsidiary level, then an alternative driver for allocating the expenses needs to be used for tax purposes that reflect the benefit to the branch/subsidiary.

Although the methodologies involved in applying Australia's transfer pricing rules to international dealings between separate legal entities are similar to those for dealings between a branch and its head office, there are differences between the taxation principles applicable to PEs and subsidiaries that may produce different outcomes among the two settings.

In a subsidiary context, a key consideration is the characterisation of the liquidity reserve charge, i.e., whether it is akin to a committed funding line (i.e. commitment fee) or as an expense related to the provision of head office services. While all categories of expenses are in principle deductible in computing the taxable profits of the Australian subsidiary, in obtaining a deduction it is important to clearly demonstrate that there is an actual or intended benefit to the Australian subsidiary and the expense is not shareholder in nature.

Amongst other things, this will need to take into account whether the Australian subsidiary is required to hold its own liquidity cushion independently or in addition to the global reserve to ensure there is no double-charging. In this regard, the APRA is currently proposing that foreign-owned subsidiaries will be required to meet the requirements on a stand-alone basis in implementing the Liquidity Coverage Ratio (LCR) under the Basel III requirements, suggesting that an additional head office charge may not be warranted. On the other hand, for foreign bank branches in Australia, APRA proposes to recognise head office liquidity support under certain circumstances.[2]

Therefore in a branch scenario, a deduction should be allowable for an allocation of the liquidity reserve expense to the extent of the committed funding line from head office. However, complications can arise in a branch scenario regarding the recognition of the dealing under Australia's attribution

[1] APRA Working Paper, *Liquidity transfer pricing: A guide to better practice*, Dr Joel Grant – March 2011.

rules and where there is no separate cost allocation but rather the bank 'recoups' the cost of carry by charging a small liquidity premium to the funding cost via the funds transfer pricing process. In this situation, a question arises as to the deductibility of the charge under Australia's domestic PE rules considering that profit attribution in relation to dealings other than the transfer of funds needs to be based on an allocation of actual income and expenses.

Japan

Deductibility of liquidity reserve expense

The deductibility of a charge arising from the maintenance of a centrally managed and provided liquidity reserve is a unique tax issue that has arisen in Japanese banking and capital markets since the 2007/8 financial crisis escalated. As these charges are only relatively recent, the acceptance and limits of the tax treatment for liquidity reserve expenses (i.e., their deductibility) are considered under general principles.

1. Deduction of liquidity reserve expense by a Japanese branch

Under Japanese tax law, transactions between a branch and its head office are generally ignored. In particular, where the head office lends– or allocates – funds to its Japanese branch and the branch pays, or recognises, interest expense with respect to this intra-entity funding, the intra-company charge is not deductible for Japanese tax purposes (unless directly traceable to a third party lender). Notwithstanding the above general principles, for foreign banks carrying on banking businesses in Japan through a branch office, in practice funding costs paid to a head office are generally accepted as deductible subject to limitation.

Although a fact dependent issue, if there is no direct funding to the bank branch in Japan in relation to the liquidity reserve expense, expenses incurred on these funds are less likely to be allowed as a deduction as interest expense.

However, if the liquidity reserve expenses allocated to a branch may be considered to be an expense incurred by the head office for the benefit of the company as a whole, it may be arguable that an appropriate amount of the liquidity reserve expense incurred by head office is deductible as a head office expense.

2. Deduction of liquidity reserve expense by a Japanese subsidiary

As far as there is no direct funding to the subsidiary in Japan in relation to the liquidity reserve expense, such expenses incurred on these funds would not be allowed as an interest expense deduction by the subsidiary in Japan.

That being said, provided that the liquidity reserve expense incurred by the parent is charged to the subsidiary as a provision of service (e.g., liquidity support fee) and the allocation of the liquidity reserve expense to the subsidiary is calculated on a reasonable basis from a transfer pricing perspective, the subsidiary may be allowed to claim a tax deduction for allocated costs of maintaining the liquidity reserve.

3. Treatment of capital gains or losses in connection with the liquidity reserve assets for either a branch or subsidiary

If there is no direct funding to the bank branch in Japan in relation to the liquidity reserve expense, expenses incurred on these funds are less likely to be allowed as a deduction as interest expense.

[2] APRA is proposing to recognise a committed funding line from head office for inclusion in the branch's cash inflow from day 16 of the LCR scenario. This would require the branch to ensure that it can survive a minimum period of 15 days out of its own resources, to cater for the possibility of delays in the receipt of head office support. It is proposed that the degree of head office support allowed would be approved by APRA on a case-by-case basis. (APRA Discussion Paper: Implementing Basel III liquidity reforms in Australia, 16 November 2011)

Where the Hong Kong branch is in a relatively less liquid position, it would be easier for the Hong Kong branch to demonstrate the support it may receive from the liquidity reserve in its ordinary course of banking operation in Hong Kong.

In the case of a branch, capital gains or losses in connection with the liquidity reserve would be subject to Japanese corporate tax if they were attributable to the Japanese branch (assuming the head office is located in a jurisdiction with which Japan has concluded a tax treaty). In case of a subsidiary, the charged amount (i.e., the net liquidity reserve expense against capital gains or losses) may be deductible.

Transfer-pricing considerations

As a cross border transaction, any deduction for liquidity reserve expenses would be subject to the transfer pricing rules, whether classified as interest or as expenses related to the provision of services. For subsidiaries, the transfer pricing rules are explicitly applicable. For branches, the transfer pricing rules should be considered to be applied implicitly, particularly where the head office is located in or the counterparty is another OECD member country.

Assuming that the liquidity reserve expense is *prima facie* deductible, the transfer pricing issue will almost always relate to the amount allocated to the branch or subsidiary. This issue has the appearance of simplicity, i.e., allocation should be based on a reasonable factor, such as the assets utilised in each jurisdiction that are implicitly supported by the liquidity reserve. However, in practice complications may arise, for example where the liquidity reserve involves the netting of exposures among jurisdictions by the head office. As these complications are fact specific, and therefore differ significantly among banks depending on how they have calculated the liquidity reserve and its expenses, there are no guidelines or audit practice from which taxpayers might obtain guidance on the transfer pricing treatment. However, in at least one discussion with the tax authorities, we have seen an understanding of the concept of netting of capital within the banking environment.

Hong Kong

Deductibility of liquidity reserve expense

1. Deduction of liquidity reserve expense by a Hong Kong branch

From a Hong Kong profits tax perspective, an expense is only deductible where it is incurred by the taxable person in the production of profits in respect of which he is chargeable to tax and the expense is of a revenue nature. The deductibility of revenue expenses (including interest expenses) of a financial institution in Hong Kong, irrespective of whether it is a Hong Kong incorporated bank or a Hong Kong branch of an overseas incorporated bank, will be governed by this general expense deduction rule.

Whether the liquidity reserve expense is deductible to a Hong Kong branch of an overseas bank will depend on whether one can demonstrate that the liquidity reserve expense is incurred in the production of taxable profits of the Hong Kong branch. The immediate question is whether the Hong Kong branch benefited from the liquidity reserve, which depends to a large extent on the relative liquidity level of the Hong Kong branch as compared with the head office and other branches of the bank. Where the Hong Kong branch is in a relatively less liquid position, it would be easier for the Hong Kong branch to demonstrate the support it may receive from the liquidity reserve in its ordinary course of banking operation in Hong Kong.

In determining the liquidity position of the Hong Kong branch, one should also take into account the local liquidity requirement imposed by the Hong Kong Monetary Authority (HKMA). Should the HKMA's liquidity requirement (which the Hong Kong branch should have already complied with) be more stringent than the requirement imposed by the regulators in the head office's jurisdiction, there is a question as to whether the liquidity reserve is indeed incurred for the business of the Hong Kong branch or other overseas branches, casting doubt to the deductibility of the allocated expense to Hong Kong branch.

Another issue to consider is the character of the liquidity reserve expense. Whilst the expense is allocated on a net basis (i.e. the net negative spread after taking into account the interest income derived from, and gain/loss on disposal of, the liquidity assets), there is uncertainty as to whether the allocated amount should be analysed for tax purposes on a gross basis. If the liquidity assets are managed by the head office outside Hong Kong and are non-Hong Kong assets, the income generated from these assets and allocated to the Hong Kong branch may be offshore sourced and not chargeable to Hong Kong profits tax. This leads to uncertainty as to whether the gross interest expense incurred in financing those liquidity assets (and also allocated to the Hong Kong branch) should be disallowed for tax deduction on the basis that it is not incurred in earning the taxable profit of the Hong Kong branch. Should this be the case, the entire liquidity reserve expense allocated to the Hong Kong branch would effectively be disallowed for tax deduction. In fact, the Hong Kong Inland Revenue Department (IRD) has raised similar challenges in considering the deductibility of net funding costs for local liquidity assets (e.g. Hong Kong Exchange Fund instruments) where the income generated from such assets are statutorily exempt from taxation.

Notwithstanding the above, there should be good commercial reasons to support a contention that the expense should be considered on a net basis and to justify the tax deduction of, at least a portion, of the net liquidity reserve expense.

All in all, the deductibility of liquidity reserve expense by a Hong Kong branch is not a straight-forward issue and will depend on the facts and circumstances of each case.

2. Deduction of liquidity reserve expense by a Hong Kong subsidiary

A subsidiary is a separate taxable entity from its parent entity for Hong Kong profits tax purposes. Where there is no actual funding from the parent entity to the Hong Kong subsidiary in association with the allocation of the liquidity reserve expense where the liquidity buffer is held in the parent entity, it would be difficult to claim that the expense is of a nature of "interest". Instead, it is akin to a standby facility fee or commitment fee where the parent entity commits to provide liquidity support as and when this is needed, and should be deductible to the Hong Kong subsidiary to the extent that it is incurred in the production of taxable profits.

To substantiate the commitment provided by the parent entity, it is crucial that legally enforceable documentation between the parent entity and the Hong Kong subsidiary should be in place. It is also important that the arm's length nature of the expense can be supported

Transfer-pricing considerations

From a Hong Kong transfer pricing perspective there is no clear precedent or guidance on whether the IRD would accept an allocation of the costs of maintaining a liquidity reserve or whether it would allow the deduction of a payment structured in some other way.

If the Hong Kong entity was a subsidiary, a key question that would have to be examined is whether a transaction that had occurred should be recognised for transfer pricing purposes. This is similar to the domestic profits tax question of

The deductibility of liquidity reserve expense by a Hong Kong branch is not a straight-forward issue and will depend on the facts and circumstances of each case.

whether the cost has been incurred in the production of chargeable profits, but the transfer pricing question would be determined by reference to Hong Kong's transfer pricing guidelines, Article 9 of any relevant double tax agreement, the OECD transfer pricing guidelines and transfer pricing case law. Assuming appropriate contracts and documentation are in place, then whether the transaction should be recognised for transfer pricing purposes is essentially a question of whether, at arm's length, the subsidiary would be willing to pay the parent company maintaining the liquidity reserve for doing so.

The second key question is whether the IRD would challenge the size of the charge that the Hong Kong entity is asked to bear. In this regard, if a cost allocation process is applied, the IRD might seek to challenge either the way in which the cost has been calculated (e.g. which source of funds has been treated as relating to the liquidity reserve) as well as the allocation key used to allocate the reserve costs. For example, if the Hong Kong entity was allocated costs on the basis of the size of its asset base and the allocation key did not take into account the liquidity position of the Hong Kong operation relative to that of its other affiliates, it could be queried by the tax authorities. If a different method/structure was used for rewarding the entity bearing the liquidity reserve, the questions from the IRD could be different.

If the Hong Kong entity was a branch of the entity bearing the liquidity reserve costs then the technical basis for the IRD challenging any allocation of costs to the branch would depend on whether the entity bearing the liquidity reserve costs was based in a treaty partner or not and this would have an impact on the way in which it went about challenging any allocation. In any case, the IRD would look at how the liquidity reserve supports the Hong Kong branch as well as the method for allocating the costs to Hong Kong.

Conclusion

The tax treatment of liquidity reserve expense is likely to receive increased attention from tax authorities. As this occurs, tax authorities in the central location are less likely to allow a deduction for the entire expense in the central location (or main locations) in which it is incurred because the expense benefits many locations. At the same time, other locations will scrutinise the connection between the liquidity reserve expense and a bank's business in that location, and will determine how the expense fits within the location's tax rules relating to deduction of expenses and transfer pricing.

Different tax authorities will undoubtedly have different views, in part due to differences in their tax rules. Because of the difficult technical issues, discussions with some of the relevant tax

From a Hong Kong transfer pricing perspective there is no clear guidance or precedent on whether the IRD would accept an allocation of liquidity reserve expense or allow a deduction of payment in another manner.

authorities may be needed to ensure that a deduction for all liquidity reserve expense can be obtained. It is hoped that, over time, a consensus will develop among tax authorities on how liquidity reserve expense should be deducted in the relevant countries, thus avoiding any double taxation that could arise from the disallowance of a deduction. Such consistency among tax authorities would mirror the cooperative and consistent approach adopted by national bank regulators. The adoption of a coherent fiscal approach across major financial centres would lessen compliance cost for banks. In turn, the alignment of the tax and regulatory rules in this area should help to promote the development of a sound and stable financial sector.

It is hoped that a consensus will develop among tax authorities on how liquidity reserve expenses should be deducted in respective countries and thus avoiding any double taxation that could arise from the disallowance of a deduction.

SINGAPORE

Carrie Lim
Director
carrie.cl.lim@sg.pwc.com
+65 6236 3650

AUSTRALIA

Gavin Marjoram
Partner
gavin.marjoram@au.pwc.com
+61 2 8266 0576

Danielle Donovan
Partner – Transfer Pricing
danielle.donovan@au.pwc.com
+61 7 3257 8102

HONG KONG

Rex Ho
Partner
rex.ho@hk.pwc.com
+852 2289 3026

Gavan Neary
Senior Manager
gavan.h.neary@hk.pwc.com
+852 2289 3546

David Mcdonald
Director – Transfer Pricing
david.mcdonald@hk.pwc.com
+852 2289 3707

JAPAN

Sachihiko Fujimoto
Partner
sachihiko.fujimoto@jp.pwc.com
+81 3 5251 2423

Akiko Hakoda
Senior Manager
akiko.hakoda@jp.pwc.com
+81 3 5251 2486

Ryann Thomas
Partner – Transfer Pricing
ryann.thomas@jp.pwc.com
+81 3 5251 2356

Australia

Recent tax changes

With the Government increasingly determined to deliver the promised 2012-2013 budget surplus, the focus on tax reform continues, in particular in areas where additional revenue opportunities lie. Significant developments over the last six months in the transfer pricing and tax consolidation regimes reflect this focus. We provide details on these below, as well as details of other key tax developments.

Review of transfer pricing rules

In what is seen as a reaction to adverse decisions in recent cases, the Government announced in November 2011 a reform to the Australia's transfer pricing rules in the income tax law and Australia's future double tax agreements (DTAs) to bring them in line with international best practice, thus improving the integrity and efficiency of the tax system.

Controversially, the announcement also stated that the Government would amend the law to 'clarify' that tax treaties provide a power to make transfer pricing adjustments independently of Australia's transfer pricing legislation, with the amendments to have retrospective effect from 1 July 2004.

The announcement was accompanied by a detailed Consultation Paper outlining the broad principles upon which any change would be based.

After a short period of public consultation, the first stage of the transfer pricing reform is currently underway with the release in March 2012 of an exposure draft of proposed amendments.

Specifically, these first stage draft measures seek to:

- ensure that the transfer pricing articles contained in Australia's DTAs are able to be applied and operate to provide assessment authority independent of Division 13 of the Income Tax Assessment Act 1936 ("ITAA36") through explicit incorporation into the Income Tax Assessment Act 1997 ("ITAA97"), and
- require the arm's length principle to be interpreted as consistently as possible with relevant guidance from Organisation for Economic Co-operation and Development (OECD).

These amendments will apply retrospectively to income years commencing on or after 1 July 2004. Public submissions on this exposure draft closed on 13 April 2012. The retrospective application of these rules was strongly opposed during the public consultation process that followed the announcement of the proposed reforms; however, the Government has decided to proceed with backdating these changes despite the tenuous basis for doing so.

The proposed changes are seen by many as being controversial because of their retrospective application. As well as retrospectivity, there are a number of other controversial aspects of the proposed changes, including:

- potential discrimination against tax treaty partner countries;
- expanding the taxing powers available to the Commissioner of Taxation (the "Commissioner") by introducing a new domestic taxing power in addition to the existing taxing powers held under Division 13 of the ITAA36 and, according to the Treasury and the Commissioner, under Australia's DTAs;
- potentially enabling the Commissioner to "reconstruct" transactions between Australian entities and related parties in treaty partner countries;
- incorporating certain "OECD guidance" into the Australian transfer

The Government intends to amend the law to "clarify" that tax treaties provide a power to make transfer pricing adjustments independently of domestic legislation. These changes will have retrospective effective from 1 July 2004.

Draft legislation has been issued to implement tax consolidation rules for company groups. The measures also contain amendments to deal with interaction of the tax consolidation regime and the TOFA regime.

pricing rules on a selective basis, which could pave the way for the Commissioner to only adopt "OECD guidance" when it particularly suits the Australian Taxation Office (ATO);

- creating a further divide between the application of Australia's transfer pricing rules (with a profit outcome emphasis) and the imposition of customs duty (which is applied on a transactional basis), and
- only partially addressing issues relating to branch profits attribution, in a way that may increase complexity and uncertainty for Australian branches of foreign companies.

According to the Treasury, the purpose of the proposed changes is to clarify the operation of the existing law. However, as explained above, the proposed changes are likely to have the opposite effect and increase complexity and uncertainty for Australian taxpayers.

So what does this mean for taxpayers?

The impact of the first stage reforms could be significant for taxpayers already involved in transfer pricing disputes with the ATO, and taxpayers at risk of ATO's scrutiny due to factors such as low profitability, cross border business restructures or high levels of related party debt. The impact is likely to be minimal for taxpayers who have already applied profit based transfer pricing methods and have derived profits that the ATO would consider to be "commercially realistic". Taxpayers should consider the extent to which the proposed changes may create uncertainty over their historic and current transfer pricing arrangements and whether this needs to be addressed through changes to transfer pricing policies, documentation or tax risk management strategies.

Next Step

The second stage of the transfer pricing reforms will involve a new set of prospective transfer pricing rules to replace Division 13 of the ITAA36. The Treasury is currently preparing an exposure draft of these new rules which will be released for public comment in future.

Wind back of 2010 consolidation changes and amendments to Taxation of Financial Arrangements interactions

On 18 April 2012, the Government released the draft legislation to implement changes to tax consolidation rules for company groups. The measures operate to wind back the "rights to future income" (RTFI) and "residual asset tax cost setting" rules that were enacted less than two years ago (refer *BCM Tax* Volume Two 2010). The measures also contain amendments to deal with the interaction of the tax consolidation rules and the taxation of financial arrangements (TOFA) regime. Details of these measures were first announced by the then Assistant Treasurer in November 2011.

Who is affected?

The changes affect groups of companies that elected to apply the tax consolidation rules, and particularly those groups who have acquired or merged with other companies since 1 July 2002.

Despite the significance of these changes, the Government set a period of only two weeks within which to receive submissions on the draft legislation. It is hoped that following consultation, the resulting legislation is introduced into the Parliament and enacted as soon as possible to alleviate further taxpayer uncertainty.

Retrospective measures

Many of the changes operate on a retrospective basis. The retrospective elements are not limited to unwinding the June 2010 changes enacted by Tax Laws Amendment (2010 Measures No. 1) Act 2010, but also in some respects, undo law which has been in place since 2002.

Companies will need to carefully consider the impact of these changes. While some prior year claims will be protected where a group has lodged a claim and received an assessment before 31 March 2011, or received an ATO ruling, most companies will not be so lucky.

These changes will "hurt"!

Many companies relied on the previous law and recognised the benefits in their financial accounts; in public announcements; in making investment decisions; or in paying dividends. Many of these companies will be adversely affected by the changes and some will need to adjust their financial accounts accordingly.

The changes which will hurt most are:

- the wind back of the measures enacted in June 2010 which operated (albeit briefly) to allow tax consolidated groups to claim specific deductions for the reset tax cost of income producing contracts and other revenue assets (other than consumable stores and work-in-progress) held by companies which join the tax consolidated group;

- a deemed goodwill treatment for non-deductible RTFI and other intangibles such as customer relationships and know-how (with retrospective effect from 1 July 2002); and

- a deemed tax cost for TOFA liabilities, including derivative contracts, equal to the accounting value at the joining time (and for those TOFA taxpayers who made the election to transition their pre-TOFA financial arrangements into the TOFA regime, apply this rule where the relevant joining time was prior to the adoption of TOFA).

Different rules for different periods

The measures contain three sets of rules covering joining times in the following periods:

- 1 July 2002 to 11 May 2010 – the "pre rules" will broadly reinstate the "old" (pre-2010) rules with new exclusions for customer relationship assets, know-how, insurance contracts, and RTFI contracts while providing a specific deduction for certain work-in-progress amounts (and subject to certain protection as noted later).

- 12 May 2010 to 30 March 2011 – the "interim rules" will broadly protect companies that entered into transactions during this period. In particular, deductions will be available over the lesser of ten years or the life of a contract for the cost allocated to RTFI contracts (with new exclusions for non-contractual assets such as customer relationship assets, know how, renewal options, and contracts to the extent they may be cancelled by the other party without penalty).

- Post 30 March 2011 – a much narrower set of rules apply on a prospective basis chiefly aimed at aligning the outcomes of a share purchase and a direct business asset purchase and to restrict the tax cost setting rules to capital gains tax assets (e.g. customer lists, trade secrets are excluded).

TOFA and consolidation interactions

The draft legislation also contains changes to the operation of the TOFA rules for consolidated groups to "ensure that the TOFA provisions operate as intended" in respect of liabilities and the TOFA transitional election. The changes will mean that:

- The head company of the consolidated group is taken to have received an amount at the joining time for the assumption of the joining entity's liabilities that will be TOFA financial arrangements of the joined group. The amount is equal to the accounting value of the liability at the joining times, regardless of which of the tax-timing methods applies. The TOFA status of the liability for the joining entity is irrelevant. As a result:
  - no deduction will be available to the extent of any unrealised losses on liabilities (e.g. out of the money derivatives and unrealised foreign exchange losses on foreign currency borrowings) at the joining time;
  - unrealised gains on liabilities (e.g. unrealised foreign exchange gains on foreign currency borrowings) at the joining time will be disregarded; and
  - allocable cost amount calculations (on joining) may need to be redone to reflect the tax-effect of the liability as a result of the amendment.
- Consolidated groups that made the transitional election and had a pre-TOFA joining time, will need to apply the transitional balancing adjustment provision and the general balancing adjustment provision (on cessation of the financial arrangement) to transitional financial arrangements (assets and liabilities) assuming that TOFA applied at the joining time. For liabilities, this will also mean applying the above TOFA/ consolidation interaction amendments.
- The 'short-cut' method (i.e. reliance on deferred tax balances) for determining transitional balancing adjustments will not be available to many consolidated groups, significantly increasing the compliance burden.
- As all of the above amendments apply retrospectively from the TOFA start time, transitional balancing adjustments may need to be recalculated.

Where to from here?

As explained above, the latest amendments involve a complex matrix of different rules and permutations depending on when a transaction took place or when a ruling or assessment was issued. Determining the precise impact of these changes for a particular company will require considerable care and analysis. It is recommended that each affected company should consider their

The Government intends to amend the general anti-avoidance rule - Part IVA. The amendments are expected to be tabled in the Parliament during the spring sitting session. The announcement appears to be as a result of recent Part IVA tax cases that have been found in favour of the taxpayers.

own position in the light of the above amendments, and seek clarification from their tax advisor where needed.

Maintaining the effectiveness of the general anti-avoidance rule (Part IVA)

In March 2012, the Assistant Treasurer announced that the Government would act to protect the integrity of Australia's tax system by introducing amendments to the general anti-avoidance provision in Part IVA of the income tax law.

The Assistant Treasurer said the amendments would ensure that the general anti-avoidance rule continued to be effective in countering tax avoidance schemes that are carried out as part of broader commercial transactions. He went on to say that despite Part IVA working effectively since its introduction, there was a need to clarify its operation to continue that effectiveness.

The announcement appears to be a result of some recent high profile Part IVA cases, where the Full Federal Court has found in the favour of taxpayers (e.g. *RCI Pty Limited v Federal Commissioner of Taxation* [2011] FCAFC 10 *and Commissioner of Taxation v Futuris Corporation Limited* [2012] FCAFC 32).

As stated in the Assistant Treasurer's announcement, "in recent cases, some taxpayers have argued successfully that they did not get a "tax benefit" because, without the scheme, they would not have entered into an arrangement that attracted tax".

"For example, they could have entered into another scheme that also avoided tax, deferred their arrangements indefinitely or done nothing at all. Such an outcome can potentially undermine the overall effectiveness of Part IVA and so the Government will act to ensure such arguments will no longer be successful."

The amendments will apply to schemes entered into or carried out after the date of the announcement and amending legislation is expected to be tabled in the Parliament during the spring sitting session.

So what does this mean for taxpayers?

Going forward, due consideration needs to be given to the implications arising from the Government's announcement. Clearly the difficulty here will lie for taxpayers seeking to formulate Part IVA position papers before the release of the proposed amendments to Part IVA (given the intention of these reforms to apply retrospectively from 1 March 2012). In such circumstances, it would be prudent for taxpayers to engage in discussions with their tax advisors on alternative avenues by which Part IVA certainty can be achieved from the tax authorities (e.g. ATO Private Binding Ruling requests).

Access all areas: the Commissioner's rights to access information of foreign subsidiaries

The recent Federal Court decision of *ANZ Banking Group Ltd v Konza* [2012] FCA 196 highlights the broad reach of the Commissioner's power to access information about the affairs of taxpayers, including information originating outside Australia when that information is held in Australia.

In summary, the Commissioner issued two notices to an Australian bank under section 264(1)(a) of the ITAA36 in relation to information about customers in Vanuatu. Section 264(1)(a) has been construed by the courts to give the Commissioner almost unfettered power to seek information (provided the notice is issued in good faith and for the purposes of the Commissioner administering the tax legislation).

The decision in ANZ Banking Group Ltd v Konza [2012] FCA 196 confirms the Commissioner's powers to access taxpayers' information, including information originating outside Australia when that information is held in Australia.

The information sought by the Commissioner related to information that was created or sourced by a subsidiary of the bank, which carries on banking operations in Vanuatu. The Australian bank itself does not carry out a banking business in Vanuatu.

For various corporate purposes, the Vanuatu subsidiary electronically sends information about its customers to the Australian bank, which is stored on a digital database in Australia for a period of time.

Justice Lander rejected each of the bank's arguments. Of particular importance in his reasoning was the fact that the information being sought by the Commissioner was already in Australia on the bank's Australian digital database. The Commissioner was only seeking information already in the possession of the bank.

The court confirmed that the Commissioner has the power under s264 (1)(a) ITAA36 to conduct a "fishing expedition".

This case highlights the broad scope of the Commissioner's statutory powers to require information to be furnished to him, and that there are limited grounds for seeking to challenge those powers.

Goods and Services Tax – sale of a corporation's property by a mortgagee or charge

On 14 February 2012, the Treasury released exposure draft legislation seeking to clarify the goods and services tax (GST) law for entities in the mortgage lending sector so that representatives of incapacitated entities will no longer need to differentiate between different provisions of the GST law and will be able to report and account under a single registration.

This follows the announcement in the 2011-12 Federal Budget that the Government would amend the GST law to clarify that Division 105 of the GST Act operates to the exclusion of Division 58 where a mortgagee in possession or control sells the property of a corporation. As the law currently stands, there are circumstances where both Divisions can apply to a mortgagee or chargee in possession or control of a corporation's property, giving rise to uncertainty regarding registration and reporting requirements.

The clarification is intended to provide greater certainty for entities engaged in the mortgage lending sector, and to reduce compliance costs for representatives of incapacitated entities.

Amending the GST financial supply and reduced input tax credit regulations

On 13 January 2012, the Treasury released an Exposure Draft of amendments to the GST financial services regulations to implement changes announced by the Government in the May 2010 budget arising from Treasury's Review of the Financial Supply Provisions.

One significant change is the introduction of a new item 32 of the GST regulation 70-5.02(2) which essentially provides for a new 55 per cent reduced input tax credit (RITC) for trustee and responsible entity ("RE") services from 1 July 2012. Item 32 will apply to a "recognised trust scheme" whose trustee makes taxable supplies to it. "Recognised trust scheme" is defined as managed investment schemes, approved deposit funds, pooled superannuation trusts, public sector superannuation schemes and regulated superannuation funds (excluding self managed superannuation funds). All services acquired by qualifying entities will attract the new 55 per cent RITC rate, including non-RITC services and other existing 75 per cent RITC items, with the following important exclusions which will still attract the 75 per cent RITC rate:

- Brokerage services;
- Investment portfolio management functions excluding acting as a trustee or RE;
- Administrative functions excluding regulatory compliance for acting as a trustee or RE; and
- Custody and master custody services.

So where to from here for taxpayers?

Item 32 will cause significant administrative difficulties for investment product providers, superannuation funds and fund service providers. Apportionment methodologies and calculations may need to be determined. For the first time, it will be necessary to take into account two different RITC rates in calculating input tax credit entitlements. This may require changes to systems and procedures used to account for GST. Many product disclosure statements, financial services guides, trustee and management agreements and other documentation currently specifically include only the 75 per cent RITC rate (or a net 25 per cent GST cost), and many trustee and investment management fees (and unit prices) are calculated having regard to this percentage. Tax invoicing arrangements will need to be revised, with different services provided by trustees and REs separately identified. New instructions for GST accounting will need to be issued to outsourced administrators and managers.

Given the proposed introduction date of 1 July 2012, the work necessary to implement the changes will need to start immediately and accordingly affected companies should contact their tax advisors sooner rather than later.

The Commissioner's approach to franking dividends

On 21 December 2011, the Commissioner issued Draft Taxation Ruling TR 2011/D8 (the "Draft Ruling") which outlines the Commissioner's preliminary view concerning the taxation of dividends paid in compliance with section 254T of the Corporations Act 2001 ("Corporations Act") from 28 June 2010. In particular, the Draft Ruling considers the assessment of dividends under the income tax law, the ability of the paying company to frank such dividends and the circumstances in which dividends will be taken to be 'paid out of profits'.

The 'balance sheet' test

Applicable from 28 June 2010, the Corporations Act was amended to replace the previous 'profits test' (in section 254T) applicable to the payment of dividends with a 'solvency' or 'balance sheet' test. With effect from the same date, the taxation law was amended to ensure that a dividend paid out of an amount other than profits is taken to have been paid out of profits for tax purposes (and accordingly, will be assessable income to a resident shareholder receiving the dividend).

When can a dividend be franked?

In the Draft Ruling, the Commissioner considers the interaction of section 254T with the taxation law and his preliminary views are that:

- a dividend paid in accordance with a company's constitution and without breaching section 254T, that is paid out of current year's trading profits recognised in the company's accounts, is not prevented from being franked merely because the company has un-recouped prior year accounting

Draft Taxation Ruling TR 2011/D8 considers the assessment of dividends under the income tax law, the ability of the paying company to frank such dividends and the circumstances in which dividends will be taken to be 'paid out of profits'.

In the 2012 - 2013 Federal Budget, it was announced that the Government will not proceed with a reduction in corporate tax rate from 30 per cent to 29 per cent, as previously announced.

losses or has lost part of its share capital. This dividend will be assessable income of the company's resident shareholders;

- a dividend paid in accordance with a company's constitution and without breaching section 254T, that is paid out of an unrealised capital profit of a permanent character recognised in the company's accounts, is not prevented from being franked provided the company's net assets exceed its share capital by at least the amount of the dividend. This dividend will be assessable income of the company's resident shareholders; and

- a distribution to shareholders (even if labelled as a dividend) that does not comply with section 254T is an unauthorised reduction and return of share capital that will be taxed under the capital gains tax (CGT) provisions of the taxation law as a CGT event, or will be taxed as an assessable unfranked dividend, depending on the particular facts and circumstances of the payment.

In expressing these views, the Commissioner explains that the "better view" of section 254T is that it does not authorise the payment of dividends, but rather, the section sets out the circumstances where a company governed by the Corporations Act is prohibited from paying a dividend. Based on this view as to the effect of section 254T, the Commissioner concludes that the concept of profits as the source of a dividend payment continues to be relevant to section 254T, and to the assessment and franking of dividends for taxation purposes. It is relevant to note that a distribution from share capital is unable to be franked.

So what does this mean for taxpayers?

It is proposed that the Draft Ruling when finalised will apply from 28 June 2010. Up until such time, companies seeking to pay dividends should ensure that they comply with the requirements of the Draft Ruling at a legal entity level and seek clarification from tax advisors where their respective position requires it.

2012-2013 Federal Budget

On 8 May 2012, the Government handed down the 2012-2013 Federal Budget.

Highlights

The Australian economy is in a holding pattern despite expectations that it will continue to outperform other advanced economies.
The two-speed economy continues to define economic performance, with:

- the mining boom continuing to grow at under nine per cent per year through to 2013-14, with $120 billion of investment in 2012-13. We are however moving into a new phase, with export prices having peaked.

- in contrast, the non-resources sectors are expected to grow at only two per cent per year, with retail prospects continuing to be hampered by ongoing high levels of consumer saving and the higher than average Australian Dollar.

It is intended that the Budget will deliver a $1.5 billion surplus in 2012-13.
The Budget has prioritised spending on health, social policy and other equity initiatives, but has not provided a comprehensive road map for lifting productivity and future economic growth.

Key budget measures

- The Government will not proceed with a reduction in the corporate tax rate from 30 per cent to 29 per cent as previously announced.

- Bad debt deductions will no longer be available for related party debt write-offs.

- Instruments that may otherwise not have satisfied the tax debt test because of Basel III capital reforms that apply to regulated financial institutions from 1 January 2013 will be treated as debt for tax purposes.

- The GST law will be amended to restore access to RITC for credit unions which rebrand as “banks”.

- Further reforms will be been made to living-away-from-home allowances and benefits for Fringe Benefits Tax purposes to better target the concession to people that are legitimately maintaining a second home in addition to their actual home for an initial period.

- The Government will remove the 50 per cent CGT discount for non-residents on capital gains that accrued after 8 May 2012.

- Commencing 1 July 2012, certain distributions from managed investment trusts to non-residents will be subject to an increased withholding tax rate of 15 per cent (from 7.5 per cent).

- The Government has reconfirmed the measures announced on 16 December 2011, in relation to the final element of the investment manager regime (IMR) measures. The final element of the IMR is an incentive that will help increase Australia’s global competitiveness as a destination for foreign ”mobile capital”.

- The Government announced that the proposed 50 per cent discount for interest income for individuals (due to commence on 1 July 2013) will not proceed.

Further information on the 2012-2013 Federal Budget is available at http://www.pwc.com.au/tax/federal-budget/index.htm.

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

Dim Sum Bond: A hot delicacy in corporate treasurers' menu

Dim Sum bonds have become a popular financial tool for raising RMB funds. This article highlights some of the key tax issues for consideration.

Renminbi (RMB) bonds have become an important financial instrument to China-focused corporate treasurers who wish to allow their corporate surplus cash to enjoy the positive carry and prospective RMB appreciation against the US dollar.

Since RMB is not a freely convertible currency, there are currently two broad categories of RMB bonds, namely:

(i) RMB bonds traded in the People's Republic of China (PRC) domestic market ("CNY bonds"); and

(ii) RMB bonds traded in offshore market, e.g. Hong Kong ("CNH bonds"), also known as "Dim Sum" bonds.

Foreign investors have a very limited access to the PRC domestic CNY bond market through financial institutions that hold the Qualified Foreign Institutional Investor (QFII) licence, unless they themselves can secure a special licence from the Chinese authorities as a QFII. On the other hand, the offshore Dim Sum bond market, which is targeted at foreign investors, is expected to grow exponentially over the next few years as a result of the Government's policy of internationalising its currency.

This article highlights some of the key PRC tax issues in connection with investing in Dim Sum bonds.

Uncertain tax position on investing in Dim Sum bonds

China's tax regime governing onshore CNY bonds and offshore Dim Sum bonds is still in a state of flux. Existing PRC tax rules grant a corporate income tax exemption for coupon interest received from bonds issued by the Ministry of Finance. However, the legislation is silent on whether this favourable tax exempt treatment can be extended to:

- capital gains arising from trading of government bonds; and
- accrued interest arising from the amortisation of discounts on the purchase price of the bonds.

So far, the Chinese tax authorities have not attempted to collect tax from foreign investors on capital gains arising from trading of government bonds. As a result, foreign investors are struggling with whether to recognise a tax provision on capital gains and discounts from trading of government bonds through QFIIs or through trading in the offshore market. There is also uncertainty as to whether the five per cent business tax should be imposed on interest and capital gains arising from investment in government bonds.

For non-government corporate CNY bonds or CNH bonds, the tax rules require the Chinese bond issuers to deduct 10 per cent withholding tax at source when interest payments are made to offshore investors or QFIIs. Recently, foreign multinationals corporations (MNCs) such as the McDonald's Group were permitted to issue Dim Sum bonds in the offshore market. It appears that interest paid from offshore CNH bond issued by foreign MNCs should fall outside the Chinese tax net. Foreign investors may thus find that the after-tax yield on investment of Chinese corporate bonds (with similar credit risk and tenor) may be higher where the bond issuer is a foreign corporation.

As far as capital gains taxation is concerned, foreign investors trading in CNY bonds in the PRC domestic market through QFIIs faced uncertain tax positions, similar to the tax issues for Chinese A-share trading, as the QFII taxation regime is unclear.

There is another grey area, which is whether capital gains derived from trading in Dim Sum bonds in the offshore market should be subject to PRC taxes. The use of an appropriate tax treaty platform to trade Dim Sum bonds may mitigate the PRC capital gains tax risk. However, as the Chinese tax authorities

Corporate treasurers of MNCs should take note of cross-border borrowing limits imposed on FIEs when on-lending bond proceeds to their Chinese affiliates.

are scrutinising arrangements which are "treaty shopping" and whether investors are "beneficial owners" for treaty claims, investors should seek tax advice before implementing a tax treaty platform arrangement.

Borrowers in Dim Sum bonds market

MNCs expanding in China see Dim Sum bonds as an emerging financing model for their Chinese operations.

To-date, MNCs such as McDonald's, Volkswagen, Caterpillar and Unilever have tapped the Dim Sum bonds market. MNC borrowers in need of RMB funding generally have two options to raise capital. They can either access the mainland China bank loan market, where rates are regulated by the People's Bank of China or, they can issue Dim Sum bonds in the offshore market, where borrowing rates are market driven, and thereafter remit the proceeds to China. The offshore RMB market appears to be the cheaper financing alternative for borrowers.

Dim Sum bond issuers should note the following when on-lending the bond proceeds to their Chinese operating entities. MNCs' Chinese operating entities normally take the form of foreign investment enterprises (FIEs) and these entities have to observe cross-border borrowing limits. The cross-border borrowing cap of a normal FIE is determined by the difference between its approved total investment and its registered capital. There is also a statutory limit on the ratio between total investment and registered capital for a FIE (see Table 1). For instance, a FIE with a registered capital of US$12 million can have an approved total investment of US$36 million, thus translating to a cross-border borrowing cap of US$24 million. A Dim Sum bond issuer should observe the cross-border borrowing limits of its Chinese operating entities to determine the extent that bond proceeds can be remitted into China by way of debt. For MNCs which have set up an investment holding company in China with a paid-up registered capital of at least US$30 million, that company has a higher

Table 1

Under US$3 million	Ratios	Minimum registered capital
Under US$3 million ($3 million inclusive)	1:0.7	70% of total investment
Between US$3 and 10 million ($10 million inclusive)	2:1	US$2.1 million
Between US$10 and 30 million ($30 million inclusive)	5:2	US$5 million
Over US$30 million	3:1	US$12 million

statutory ratio between total investment and registered capital of 4: 1. Hence, offshore Dim Sum bond issuers with a Chinese investment holding company structure have greater flexibility in pushing debts down to China.

Additionally, foreign MNCs should take note of Chinese thin capitalisation rules in debt push-down structures. Under these rules, the tax authority may deny tax deductions on excessive interest paid to related parties if the related party debts of the taxpayer exceed a prescribed debt-equity ratio (i.e. 2:1 for non-financial institutions). Related party debts for this purpose include direct loans between related parties, back-to-back arrangements and loans guaranteed by related parties that have joint and several repayment obligations.

Where the taxpayer's debt-to-equity ratio exceeds the 2:1 safe-harbour, further analysis and documentation are required to refute a challenge from the tax authorities. Taxpayers should develop robust transfer pricing documentation to support that their related party financing arrangements are at arm's length and ensure that there are genuine business reasons for borrowing beyond the safe-harbour ratio.

The way forward

The trading volume of Dim Sum bonds is increasing exponentially in the offshore market as foreign investors have a strong appetite for RMB denominated assets. Dim Sum bonds are also gaining traction with MNC issuers due to growing funding needs for their Chinese operations. Borrowers and lenders in the Dim Sum bonds market need to understand the Chinese tax and regulatory exposure in order to successfully unlock the opportunities of the market.

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

Ellen Sheng
Senior Manager
PwC China
+86 21 2323 2913
ellen.sheng@cn.pwc.com

China

2012 China tax challenges for foreign bankers: are you ready?

Foreign banks in China continue to fight hard to define their role in the Chinese market and to expand their operations. Despite the various regulatory constraints and tightened liquidity, foreign banks continue to redefine the market segments that offer them the opportunity to excel and plot path of stable and long term expansion. Against a more uncertain macroeconomic and financial environment, foreign banks appear to have added focus to their China strategies. The outlook will be very challenging, but foreign banks in China remain determined to push ahead with their growth strategies.

This article highlights some of the latest developments in the China tax and regulatory regime that may affect foreign bankers operating in the fast growing China market.

Problematic business tax rules on composite financial transactions

China's business tax regime continues to be one of the biggest tax challenges to foreign banks. The existing business tax system sets out four separate financial service income baskets, each designated for a distinct category of transactions, being foreign exchange, stocks (equities), bond and others. The existing rules which were established more than 15 years ago, restrict the assessment of taxable gains and losses among different basket of transactions and over periods of time. Accordingly, losses in one basket cannot be used to offset profits in another basket, even if they occur within the same quarter. Also, unutilised losses cannot be carried forward to offset gains in subsequent years, even if both such profits and losses accrue in the same income basket. This approach does not take into account the business realities which exist in today's more complex financial market, in which best market practices require that overall transactions actually consist of multiple transactions. Further, the current rules appear to ignore the fluctuations of business cycles that often play out well beyond the boundaries of one year. As a result, the current business tax regime can lead to an onerous and unfair result over the long term due to the fact that the tax structure was not designed to consider the practical realities of a series of financial transactions rolled out over a long period of time.

A classical example is where a bank invests in a fixed-interest bond and chooses to hedge the resulting interest rate risk exposure by executing an interest-rate swap or a series of forward-rate agreements. In such a case, although the actual net gain or loss on the two component transactions when reviewed together might be zero or de minimis due to the hedging, changes in interest rates may result in a profit in one component (i.e., the bond or the swap) while at the same time incurring a loss of a similar magnitude in the other component. Under the current rules, the five per cent business tax applies to the profitable component without allowing a deduction for the loss in the other components that may be inseparable parts of the overall transaction.

This is particularly problematic in the case of hedging transactions, where the net gain or loss overall will be modest in pre-tax terms, because by design it is nearly always intended to result in a gain in one component, offset almost exactly by a loss in the other component. As a result, some level of business tax is likely to be payable even though the overall transaction may generate no significant profit.

There is an urgent need to reform the existing business tax rules so that financial transactions can be taxed on a net basis without segregating a single composite transaction into different baskets. Otherwise, the current onerous business tax consequences may discourage market making and reduce financial market liquidity, thus impeding further development of financial markets. Reform through making the transactions subject to value-added tax (VAT) rather than business tax could be a solution for the banking industry in China to eliminate inefficient taxation which may otherwise impact financial market liquidity.

VAT reform for service industries

The long-awaited transformation of business tax to VAT for PRC service industries has been recently kicked off

The current business tax regime does not cater to today's complex financial markets and fluctuations in business cycles. Reform through implementation of a VAT regime could be a solution for the banking sector in China to eliminate inefficient taxation that may otherwise impact financial markets liquidity.

Tax authorities in major cities have recently introduced special tax audit programs focusing on investigation of taxpayers' falsified disbursements not supported by valid invoices.

when Shanghai launched a pilot program of VAT reform on certain service industries in January 2012. Thereafter, other first tier cities in China, including Beijing and Shenzhen, have indicated their intention to follow Shanghai and launch similar pilot VAT programs for selected service industries in the near future.

At this stage, the banking sector in China has been excluded from the existing pilot VAT reform program pending Ministry of Finance's more robust study of the development of the appropriate VAT rules for the Chinese banking sector. Nevertheless, the pilot VAT reform on other service industries has already created an unfavourable impact to bankers. In particular, various service providers in Shanghai, including lawyers, accountants, IT consultants, logistic agents and equipment leasing companies have started to add VAT to invoices to their customers effective Jan 2012. Banks buying these services in Shanghai are required to pay the VAT on the invoices but cannot recover such VAT paid because it is not creditable against the business tax payable by banks. Meanwhile, banks in Shanghai engaging services from overseas service providers are also required to withhold VAT on fees paid to overseas providers. This increases the tax costs to service providers rendering services to banks in Shanghai and may trigger new pricing disputes between the banks and their service providers.

Tax audit on falsified expense claim

In order to combat the widespread tax evasion in China through the use of fake invoices, tax authorities in major cities have recently introduced special tax audit programs focusing on investigation of taxpayers' falsified disbursements not supported by valid invoices.

The banking sector appears to be one of the major targets for this special tax audit program given that bankers normally claim significant travelling expenses and entertainment expenses during their normal course of business which may be vulnerable to abuses. Over the last twelve months, the Chinese tax authorities have made substantial tax adjustments in a number of bank tax audit cases whereby a significant amount of the banks' normal business expenditure, e.g. hotel charges, travel agency fees, entertainment expenses and staff housing expenses claimed by their employees were found to be fictitious and accordingly, not deductible.

Meanwhile, foreign banks in China should strengthen their expense reimbursement administration systems to ensure that their accounting and administrative staff are equipped with the right tax knowledge to identify fake invoices on expense claims. More robust internal audit programs should be introduced to control the expense disbursement cycle to ensure that all major expense claims are supported by proper invoices.

Transfer pricing

Over the last couple of years, the PRC tax authorities have become tougher on foreign bank transfer pricing issues, in particular on the contemporaneous transfer pricing documentation content and deadlines. One of the biggest transfer pricing challenges for foreign banks in China is headquarters charges.

Multinational banks generally have regional hubs or head offices providing support and assistance to their Chinese branches or locally incorporated subsidiary. This support can take the form of accounting, human resources, legal, regulatory, administrative or management assistance. Most multinational banks have global policies determining their pricing of support services and head office support and in many cases there is also global transfer pricing documentation describing the pricing mechanism. In recent years, the size of the support service fees charged to foreign banks branches or locally incorporated entities in China has increased and it is likely that there will be more focus on this area as a result.

In China at present, however, some subsidiaries and branches of foreign banks are not charged for the support services that they receive because the extra costs could cause them to make losses or because they have not received tax or regulatory approval to pay such fees. Where this is the case and there is no

charge, overseas transfer pricing tax rules may require foreign banks' headquarters to impute a service fee or restrict headquarters from deduction of costs relating to the China entity.
Where significant support service fees are charged to a Chinese entity, or where an entity wishes to apply for clearance to pay support fees, it is often important that specific Chinese transfer pricing documentation is compiled. In most cases transactions of this type in China are priced using an allocation of costs with no mark-up or they are priced on a fixed fee basis. The biggest transfer pricing concern for foreign banks is demonstrating to the PRC tax authorities the local benefit derived from the services and justifying that they have only been charged for their fair share of the expenses.

Last year, both the China Banking Regulatory Commission and the local tax authorities conducted various surveys of foreign banks regarding the nature of their service fee payments to overseas headquarters. The PRC tax authorities are often sceptical and may make extensive queries on this subject.

New permanent establishment rules for suitcase bankers

Bankers flying into China to work on an IPO mandate, project finance and corporate finance deals are currently on the radar screen of the PRC tax authorities.

Under most of Sino-foreign tax treaties, when overseas offices of foreign banks send employees to China to perform services, the overseas offices would not be at risk of a taxable presence in China unless such activities continue for the same or a series of connected projects for a period or periods aggregating more than six months within any twelve month period. In the past, the counting of days for the purpose of this six-month taxable presence test in China has been adversely interpreted by the PRC tax authorities in *Tax Ruling No. 403* issued in 2007.

For the purpose of determining a service permanent establishment, *Tax Ruling 403* provided that each calendar month starts from the first time an employee of an overseas entity enters China to perform services to the last time an employee is present in China for the same or connected projects, regardless of the number of days that the employee actually spends in China during any calendar month. During this period, however, for each consecutive 30 days that the overseas entity does not have an employee in China to perform services for the project or connected project, a month will be deducted from the total number of months. If by using this method of counting the total number of months exceeds six months in any twelve-month period, the overseas entity will be deemed to have a permanent establishment in China. Under this method, one day can equal one month, and thus it is possible that seven months of just one day of presence could theoretically create a service permanent establishment.

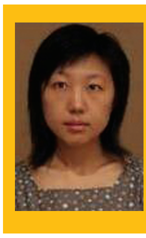
Over the past years, this "one day equals one month" method has caused widespread concern amongst the foreign banking sector in China. Recently, China issued a notice to repeal the above unfavourable counting method for determining the "six-month" service permanent establishment threshold. Foreign banks now have greater flexibility in dispatching people to China to provide services for up to six months without necessarily creating service permanent establishment exposure in China.

The way ahead

PwC's survey of Foreign Banks in China finds that foreign banks continue to believe that China offers rich opportunities. They also continue to believe they will only be able to exploit these opportunities if the playing field is level, and the regulators across the sector facilitate the growing internationalisation of the Chinese economy.

There are, however, a wide variety of upcoming tax challenges faced by foreign banks in China. As the Chinese tax authorities gradually become more sophisticated in their tax audit approach and more aggressive in their enforcement activities, the need for awareness of these challenges and early preparation to deal with them cannot be overstated.

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



April Ma
Manager
PwC China
+86 21 2323 3025
april.ma@cn.pwc.com

Hong Kong
Transfer pricing takes a step forward in Hong Kong with the launch of an APA programme

On 29 March 2012, the Hong Kong Inland Revenue Department (IRD) took an important step by formalising an Advance Pricing Arrangement (APA) programme in Hong Kong. The IRD issued *Departmental Interpretation and Practice Notes Number 48 – Advance Pricing Arrangement* ("DIPN 48"), which outlines the new APA regime in Hong Kong and its implications for taxpayers, and provides guidance on the APA framework, application and negotiation process as well as other procedural points of interest.

Highlights of the new APA programme

The APA programme is open to all resident and non-resident enterprises with a permanent establishment in Hong Kong that are subject to Hong Kong profits tax and have related party transactions pertinent to Hong Kong. The IRD does not charge an APA application fee though taxpayers will need to meet certain thresholds for an APA application. For transactions involving services, the threshold is HK$40 million per annum.

The APA process follows five stages as commonly seen in other APA programmes around the world, being (1) pre-filling (which involves details regarding the scope of the APA, covered transactions, collateral issues and proposed methodologies), (2) formal application, (3) analysis and evaluation, (4) negotiation and agreement, and (5) drafting, execution and monitoring. Similar to APAs in other jurisdictions, Hong Kong APAs will not agree precisely the actual profit for the taxpayer but will instead stipulate the methodology to be used to determine the transfer pricing.

Once concluded, APAs will be in effect for a period of three to five years, depending on the actual agreement between the taxpayer, the IRD, and the relevant treaty partner(s), and may be renewed with the consent of all parties.

Depending on the case and subject to the Inland Revenue Ordinance, the IRD may consider taxpayer requests for rollbacks of the agreed transfer pricing methodology under the APA for prior years.

The IRD has indicated a tentative time frame of 18 months (depending on the availability of the relevant competent authority and complexity of the case) from the start of the formal application process to the conclusion of an APA.

At this stage, the IRD prefers to consider bilateral APA (BAPA) or multilateral APA (MAPA) applications but it will consider unilateral APA applications as well in certain circumstances. The preference for BAPA and MAPA reflects the IRD's intention to focus on international tax issues that arise as a result of cross-border related party transactions involving countries that are double taxation agreement (DTA) partners with Hong Kong and that can be resolved through the mutual agreement procedures under article 25 of its double tax agreements. To date, Hong Kong has signed 23 DTAs and is concluding / negotiating 14 more DTAs.

Potential implications for the Financial Services industry

DIPN 48 does not specify that the new APA programme will apply to any particular transactions or industries but the IRD has mentioned that APAs may be appropriate for pricing global trading arrangements. Other potential topics that financial services taxpayers might want to cover include intra-group services and investment banking.

Helpfully from a financial services perspective, the APA programme will cover the attribution of profits to permanent establishments as well as transfer pricing between legal entities.

In practice, it is likely that only financial services taxpayers with large related party transactions will consider a Hong Kong APA. Alternatively, taxpayers seeking a BAPA to manage transfer pricing tax risk in countries such as China, Korea or Japan may engage Hong Kong's IRD in a BAPA in order to have a counterpoint in their negotiations with the China's State Administration of Taxation, Korea's National Tax Service and Japan's National Tax Agency.

David Mcdonald
Director
PwC Hong Kong
+852 2289 3707
david.mcdonald@hk.pwc.com

DIPN 48 outlines the new APA regime in Hong Kong. It provides guidance on the APA framework, application process as well as other procedural points.

India

India Budget 2012: India at a cross-road

Though foreign investors undoubtedly heaved a sigh of relief with the deferment of General Anti Avoidance Rules (GAAR) by a year, the changes brought about by the Finance Act, 2012 (the "Finance Act") introduced by the Finance Minister recently could define India's taxation history. The year started with a landmark decision from the Apex Court, in the now-famous *Vodafone* case dealing with taxation of a transfer of offshore holding entities of an Indian business. While pronouncing the judgement in favour of the taxpayer, the Apex Court urged that the doctrines like "limitation of benefits" and "look through" are matters of policy and it is for the Government of the day to have them incorporated into the law. The Government seems to have been inspired by the verdict as it proposes to introduce certain far reaching changes to the income tax regime.

This article provides an overview of the key changes affecting foreign investors and foreign banks.

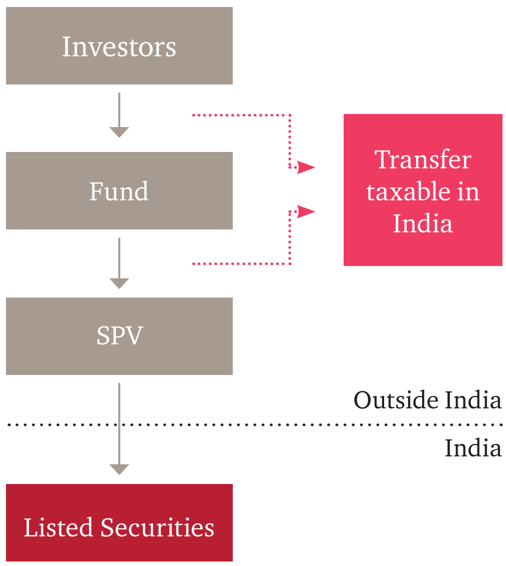
Offshore transfers

The proposed changes to the Finance Act seek to introduce provisions that virtually taxes all offshore transfers where there are underlying Indian assets. Any transfer of a share or an interest in a foreign company or entity is caught if the share or interest derives, directly or indirectly, its value "substantially" from the assets located in India. The amendment is proposed to take retrospective effect from 1 April 1962.

The meaning to be assigned to "substantial value" has not been clarified and no thresholds are prescribed. In the context of foreign institutional investors, the following scenarios could emerge: –

- The transfer or redemption of shares / units by investors in an offshore fund which is predominantly investing into India could be taxable in India.

- Where the investment by a fund into India is through a special purpose vehicle (SPV) (with the capital structure of the SPV usually mirroring that of the Fund), redemption of capital by the SPV to remit sale proceeds to the Fund could be taxable in India.



The proposed changes to the Finance Act seek to introduce provisions that virtually taxes all offshore transfers where there are underlying Indian assets. The amendment is proposed to take retrospective effect from 1 April 1962.

While the current GAAR provisions in the Finance Act are largely similar to that proposed in the DTC some provisions are wider than that introduced in the DTC.

If the provisions are applied literally, there could be taxation of the same gains at multiple levels as and when there is up-streaming of profits by way of redemption of capital in a multi-tier holding structure. These appear to be unintended consequences for an offshore fund structure; however, the provisions are drafted widely.

Representations are being made to the Government to seek clarifications on various matters, including:

- The taxability of profit repatriation to the investors by an offshore fund which had been previously taxed on the gains from the sale of Indian securities; and
- Implementation details such as the meaning of the term "substantially" and the manner of computing the gains (long term/short term, FIFO, conversion into Indian currency, etc).

Where the investments in the Fund/SPV are held as stock-in-trade, gains on transfer, being in the nature of business income, may not be liable to tax in India if the investors or the Fund do not have any business connection with, or operations, or permanent establishment in, India.

Further, in connection with the provisions dealing with offshore transfers, the benefits of tax treaties may be claimed.

The curious case of GAAR

The Finance Act introduces GAAR in the domestic law, to be effective from 1 April 2013.

Overview

GAAR provisions were first proposed as a part of the Direct Taxes Code (DTC) in 2010. The proposals drew sharp reactions, especially from foreign investors, given the wide ambit thereof. The DTC was referred to a Parliamentary Standing Committee (PSC) for its recommendations. The PSC suggested many changes, some of which have been accepted by the Government. Nevertheless, while the current GAAR provisions in the Finance Act are largely similar, some provisions are wider than that introduced in the DTC.

Key features of GAAR provisions

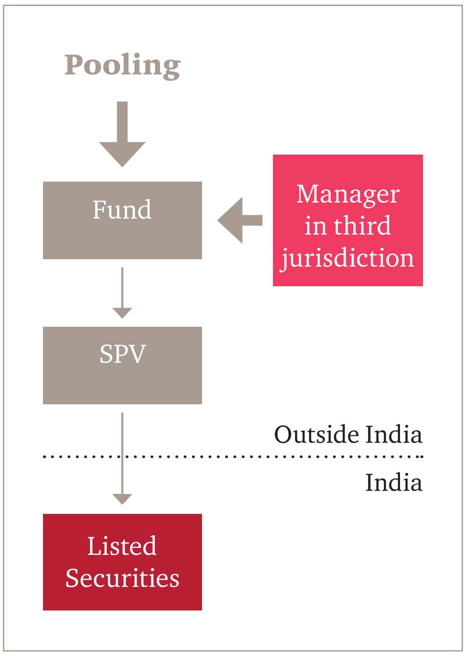
Some of the salient features of the GAAR provisions are as follows:

- GAAR can be invoked if the tax payer has entered into an "impermissible avoidance arrangement". An arrangement can be declared as impermissible if its purpose is to obtain a tax benefit and it:
  - results, directly or indirectly, in the misuse or abuse of tax laws;
  - lacks or is deemed to lack commercial substance; or
  - is not for bona fide purpose.
- Wide powers are conferred on the Revenue authorities to disregard or re-characterise the arrangement once GAAR is invoked; such powers include re-determining the place of residence or situs of an asset or a transaction for tax purposes, disregarding any corporate structure, recharacterising equity into debt, capital into revenue or vice versa etc.
- Further, limited treaty override provisions are also included in GAAR provisions. This is in contrast to the current tax laws, wherein a non resident investor has the option of being governed by the provisions of the domestic law or the tax treaty, whichever is more beneficial.

Consequences of GAAR for foreign investors/foreign institutional investors

Many foreign investors or Foreign Institutional Investors (FIIs) have invested in India through jurisdictions having a favourable tax treaty with India. The key concern amongst such foreign investors/FIIs is the potential denial of treaty benefits if the Revenue authorities invoked the GAAR provisions to attack their structures. Capital gains earned by such foreign investors/FIIs, other than long-term capital gains which are exempt under the domestic tax law, may now be potentially liable to India taxation. To soften the impact and to provide parity between FIIs and other foreign investors, the Government has reduced the rates of tax on short-term capital gains from 20 per cent to 10 per cent (without any indexation benefits).

In the context of offshore funds, the two critical aspects are the pooling jurisdiction and the jurisdiction of the Investment Manager (IM). Consider a typical scenario like the one depicted below.



Funds from investors for India investments are pooled in a jurisdiction, which may be routed through another jurisdiction. The IM may be domiciled in an altogether different country. If there are no commercial or non-tax reasons for investing into India through this structure, it could be disregarded under the GAAR regime. This was also indicated by a senior Finance Ministry official in a post Budget interview. It was suggested that "post box" companies, could be denied treaty benefits.

On the other hand, in a structure where the IM (along with personnel with adequate experience) is domiciled along with the pooling vehicle in the same jurisdiction, the risk of GAAR being successfully invoked may be mitigated.

Emerging approaches

As IMs debate on the potential impact of GAAR provisions, some of the discussions relate to the following:

- Relocation of the pooling vehicle to a jurisdiction which is a financial centre and hub of asset management activities where asset managers and key personnel/traders can also be domiciled;
- Tax requirements for availing treaty benefits. For example, in Singapore, there is a lead time of two years (or arguably, at least 13 months) to avail treaty benefits. There are also objective conditions like incurring of prescribed amount of expenditure;
- The income tax laws / regulatory requirements in the overseas jurisdiction;
- Availability of credit for Indian income taxes, if any;
- The attendant tax costs and potential tax risks of migration to the new platform;

There are a number of approaches to the potential impact of GAAR provisions. These need to be evaluated, against commercial circumstances for each taxpayer.

Provisions have been introduced to clarify with retrospective effect, that non-resident payers are liable to withhold taxes on payments to other non-residents which are chargeable to tax in India.

- Availability of past losses for set-off, if any, where treaty benefits are sought to be denied. This is critical as many Funds have incurred tax losses in the past which they may not have claimed assuming treaty benefits were available. This may become a contentious issue going forward; and

- Approaching the Revenue authorities for Advance Rulings to seek certainty of tax treatment.

Taxation of participatory notes or p-notes

Participatory notes ("P-notes") are issued by institutional investors registered as FIIs to offshore investors who wish to have exposure in Indian stock markets without having to undergo Indian registration requirements.

There could be two potential challenges in a P-note structure – GAAR and the provisions seeking to tax offshore transfers. The latter may not be of great concern where the P-notes are structured as return swap contracts and the P-note holders are not entitled to any shareholder rights in the FII entity issuing the P-notes. In cases where a FII issuing the P-notes is domiciled in a treaty jurisdiction, such issuing entity is exposed to the risk of denial of treaty benefits under GAAR, as discussed above. The issuing FII entity in such a case is likely to pass on the tax cost to the investors.

Withholding obligations

After the Apex Court's decision in the *Vodafone* case, the position in the law is that non-residents are not obliged to withhold taxes if they do not have a presence in India. The Act seeks to clarify with retrospective effect, that non-resident payers are liable to withhold taxes on payments to other non-residents which are chargeable to tax in India.

Bank subsidiarisation

The Reserve Bank of India is formulating a scheme for subsidiarisation of Indian branches of foreign banks to ring-fence the banks' capital and Indian operations from external shocks. To shore up this effort, the Finance Act proposes to provide tax neutral treatment for subsidiarisation of bank branches.

The Finance Act now provides for exemption from capital gains tax on conversion of the branches of foreign banks into subsidiaries, subject to compliance with certain conditions. The unabsorbed depreciation, set off and carry forward of losses, tax credit in respect of tax paid on deemed income will be allowed with some exceptions and modifications which may be notified subsequently.

Concluding remarks

Developed countries like US and Australia have codified anti-abuse provisions in their domestic law. Countries like UK are contemplating to introduce the same. China and Australia have provisions seeking to tax offshore transfers. Thus, India seems to be following the footsteps of some of the large developed and emerging economies of the world.

From foreign investors' standpoint, the crucial element which is absent, which the Apex Court extolled in its decision in *Vodafone's* case, is tax policy certainty. Given the sweeping nature of the provisions, potential abuse by a revenueminded officer cannot be ruled out. To quote some of the Apex Court's observations:-

"Certainty is integral to the rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational choices in the most efficient manner... Investors should know where they stand".

One will have to closely monitor the developments in the coming days. IMs and foreign investors need to evaluate the potential impact of the proposals on their fund structure and take necessary actions, as may be required. It is also expected that foreign banks would now seriously consider converting their Indian operations into subsidiaries in the near future.

Sunil Gidwani
Partner
PwC India
+91 22 66891177
sunil.gidwani@in.pwc.com

Nehal D Sampat
Associate Director
PwC India
+91 22 66891120
nehal.d.sampat@in.pwc.com

Dipesh Jain
Manager
PwC India
+91 22 66891193
dipesh.jain@in.pwc.com

Indonesia

Tax developments in Indonesia

Revision of the rules on withholding tax mechanism on bonds

The Minister of Finance published regulation *No. 07/PMK.011/2012* ("PMK-07") which took effect on 1 February 2012. The PMK-07 serves as a revision of the implementing regulation *No. 85/PMK.03/2011* ("PMK-85") with the following key changes:

- Netting of losses is allowed – Netting of interest income against a loss incurred in a sale transaction when calculating the final income tax due is now allowed under PMK-07, whereas it was prohibited under PMK-85.

- The First-In-First-Out (FIFO) method is no longer mandatory for all transactions. The FIFO method is only required when the bond acquisition cost and date is unknown.

PMK-07 also provides transitional articles that cover the calculation of the final withholding tax on bonds interest from 23 May 2011 until prior to the issuance of the regulation PMK-07 as follows:

- If the acquisition cost and date of a bond sale transaction is available, the bond interest and discount at the time of sale is calculated using either the actual acquisition cost or the FIFO method; however if such information is not available, the FIFO method is applied.

- Netting of interest income against a loss incurred is permitted. Though this transitional clause is intended to provide fairness to taxpayers, it would be quite challenging to trace transactions over the past eight months and revise the relevant tax calculation and withholding tax to comply with this clause.

Revision of transfer pricing regulations

On 11 November 2011, the Directorate General of Taxes (DGT) issued *PER-32/PJ/2011* ("PER-32") which serves an amendment of transfer pricing regulation *No. PER-43/PJ/2010* ("PER-43").

The key changes of PER-32

Transfer Pricing Documentation Requirements

While PER-43 required all transactions exceeding IDR 10 million (circa US$1,100) per annum (p.a.) (circa US$1,100 p.a) with a related party to be accompanied by transfer pricing documentation (TPD), the new regulation offers flexibility by limiting the TPD requirement to the following related party transactions with transaction value exceeding IDR10 billion p.a. (circa US$11,000 p.a.):

- Cross border related party transactions conducted by domestic taxpayers or permanent establishments (PEs) in Indonesia.

- Domestic related party transactions, if they are carried out with a motive to enjoy different tax rates. Examples mentioned in this regulation include taxpayers who are subject to final -tax, oil and gas contractors, or taxpayers who are subject to luxury sales tax.

Selection of transfer pricing method

While PER-43 strictly requires the use of a prescribed hierarchy in selecting the most appropriate methods, PER-32 has adopted the most appropriate method approach in line with OECD guidelines.

New transfer pricing regulations relax documentation requirements for related party transactions exceeding US$11,000 p.a. for certain transactions.

Filing of TPDs

On 27 April, 2012, a clarification letter No. S-479/PJ.033/2012 was issued by the DGT which serves as a clarification to the PER-32 stipulating that TPDs should be filed upon request of the DGT.

New implementing regulation on tax disputes

The government has issued regulation *No. 74/2011* ("PP-74") as the new main implementing regulation of the General Tax Provision law. Several of the important rules covered by PP-74 are set out below:

Mutual Agreement Procedure

Mutual agreement procedure (MAP) can be applied in Indonesia to reach mutual agreement to resolve tax disputes regarding cross-border related party transactions. GR-74 provides flexibility for taxpayers to apply for a MAP and to continue local dispute resolution at the same time. Local dispute resolution includes applying for a tax objection, appealing to the Tax Court, and requesting a reduction in or cancellation of administrative sanctions. However, GR-74 includes the restriction that a MAP application shall be discontinued if an appeal decision is declared by the Tax Court prior to the finalisation of the MAP. If one of the parties is not satisfied with the Tax Court decision, a judicial review by the Supreme Court is still allowed.

Advance Pricing Agreement

Any documents used during the negotiation of an advance pricing agreement must be returned to the taxpayer if no agreement is reached. The documents cannot be used by the DGT as the basis for conducting a tax audit or audit for preliminary evidence.

Interest Compensation

PP-74 stipulates that interest compensation cannot be granted if the overpayment is attributable to decisions on objections, decisions on appeal, or decisions on judicial reviews of underpaid tax assessments or additional underpaid tax assessments that are:

- approved in the audit closing conference or verification result and paid before submitting an objection; or
- not approved in the audit closing conference or verification result, but paid before the submission of an objection, application for appeal or judicial review, or before the issuance of a decision on objection, appeal, or judicial review.

Ex-officio assessments

Corporate taxpayers now can be issued with an *ex-officio* assessment if the taxpayer does not meet certain obligations during a tax audit and so the taxable income cannot be calculated correctly. Such obligations include not showing and/or lending documents required for the taxable income calculation, not providing the opportunity to enter the premises and/or not providing information and assistance to ensure the execution of an audit.

Verification procedures

In PP-74, the term "verification" is reintroduced and defined as a series of activities to test the fulfillment of subjective and objective obligations or tax calculations and payments to issue tax assessment letters, issue or cancel a Tax ID Number, and/or to affirm or revoke VAT-able Entrepreneur status. The verification is conducted based on the taxpayer's application or information that is owned or obtained by the DGT to issue tax assessment letters (e.g. withholding tax slips and confirmation of value-added tax (VAT) invoices).

Relaxation of the timing for issuing VAT invoices

On 3 August 2011, DGT issued Circular Letter No. SE-50/PJ/2011 ("SE-50") which provides clarification on the timing for issuing VAT invoices. The regulation is relevant to banks which generate VAT-able income based on the Circular Letter No. SE-121/PJ 2012 with respect to the confirmation of treatment of VAT on banking services as well to other financial services which are subject to VAT under the prevailing VAT regulations.

In general, VAT collection is based on the accrual principle where income or receivables are acknowledged when a transaction takes place. The recognition of revenue or receivables is indicated by the issue of a commercial invoice, which is a source document for this recognition and a basis for recording it.

The letter states that a VAT invoice does not have to be separate from the commercial invoice. The VAT invoice may be in the form of a commercial invoice or a particular document designated as a VAT invoice by the DGT. In addition, the letter also confirmed that in the case of the delivery of taxable goods or services that are completed within a particular period, the VAT invoice shall be issued at the time of the receipt of a term payment for a delivery of partial work.

The DGT's plan and strategy for year 2012

The DGT issued a regulation *No. SE-07/PJ/2012* dated 2 March 2012 outlining the DGT's plan and strategy for the year 2012.

The regulation stipulates that the DGT would focus to strengthen the monitoring, evaluation and control of the tax payer's obligation. For 2012, the target revenue from tax audit for year 2012 is IDR13.3 trillion (circa US$1.4 billion).

The DGT's tax audit focus will be on industries with the following parameters:

- produce significant contribution to the economy and tax revenue generation;
- have low compliance rate in the past;
- have high ability to pay taxes in 2012; and
- public interest entities.

Banks, insurance and pension funds are included in the 2012 DGT tax audit focus.

Transfer pricing is also an area of the DGT focus in 2012. The DGT requires the head of tax offices to form a task force to improve the quality of transfer pricing audit.

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

Taiwan

Proposed tax on capital gains from securities & futures transactions and their implications for the FS industry

On 12 April 2012, Ministry of Finance (MOF) announced a draft proposal to impose tax on capital gains derived from Taiwanese securities and futures transactions. The potential impact of these developments for the financial services industry are provided below.

Overview of draft proposal

The proposed tax on capital gains was one of the tax reform committee's top priorities because it is considered as a measure to fulfill the Government's prime objectives in bringing in additional tax revenues by broadening Taiwan's existing taxation base and promotion of a fairer taxation environment.

Under the proposal, individual taxpayers' capital gains on securities and futures transactions will be taxed at a flat rate under the regular income tax regime. As for corporate taxpayers, tax on capital gains remained to be collected under the Alternative Minimum Tax (AMT) regime, but at an increased AMT rate with reduced exemption amount. On the other hand, foreign companies without a fixed place of business or business agent in Taiwan are excluded from the draft proposal. The proposed tax on capital gains is expected to take effect from 2013 if the bill is passed by the Legislative Yuan.

Details of the draft proposal

Salient features of the draft proposal are summarised as follows:

	Individual Taxpayer	Corporate Taxpayer
Taxation Method	• Included under the regular income tax regime with amendment thereon. • Taxed separately but filed with other taxable income on the income tax return.	• Included under the current AMT regime. • AMT rate to be increased. • Exemption threshold to be reduced.
Taxpayer	Residents and non-residents.	Enterprises having a fixed place of business or business agent in Taiwan.
Securities Subject to Taxation	• Shares issued by a company, regardless whether it is listed on the Taiwan Stock Exchange (TSE) or traded over-the-counter (OTC); or shares[1] issued by an emerging company. • Beneficiary certificates of privately-placed securities investment trust funds. • Futures or options traded on the Taiwan Futures Exchange.	• Securities: – Shares[1]: Regardless whether it is listed on the TSE or traded on the OTC; or shares[1] issued by an emerging enterprise. – Bonds: Government, corporate, or financial bonds. – Others: beneficiary certificates, call/put warrants, Taiwan depository receipts, stock warrant certificates, etc. • Futures or options traded on the Taiwan Futures Exchange.

[1] Shares refer to share certificates, certificates of entitlement to new shares, certificates of share payment, and documents showing the entitlement to the shares.

	Individual Taxpayer	Corporate Taxpayer
Year of taxation	Capital gains generated in 2013.	Capital gains generated in 2013.
Exemption amount	Capital gains exceeding NTD 3 million per tax filing unit per annum.	Basic income exceeding NTD 0.5 million (the current exemption amount is NTD 2 million).
Tax rate	Taxed separately at 20% apart from other taxable income.	The existing 10% AMT rate will be increased to 12%.
Determination of taxable income	On an annual basis: transaction price – original costs – necessary expenses – exemption amount.	On an annual basis: transaction price – original costs – necessary expenses.
Determination of original costs	• Original cost is computed based on the "first-in first-out" method and is determined by one of the methods below, whichever is higher: 1) Original purchase cost; or 2) Shares obtained before 31 December 2012: – The closing price on the last transaction date in 2012 for shares issued by a company listed on the TSE or traded on the OTC; or – The average transaction price on the last transaction date in 2012 for shares issued by an emerging company.	• Original cost is computed as follows: 1) Shares: Specific identification method, weighted average method, moving average method, or other methods approved by the competent authority. 2) Futures & Options: First-in-First-out method, but specific identification method can be utilised for futures/options where they are liquidated before maturity. • The original costs of obtaining the securities are recognised based on those recorded in the accounting books.
Necessary expenses	Including securities transaction tax (STT), handling fees, and other associated expenses, etc.	Including STT, handling fees, and other associated expenses, etc.
Loss carry-forward	Capital losses can be deducted from capital gains in the current year and carried forward for 3 years thereafter.	Capital losses can be deducted from capital gains in the current year and carried forward for 5 years thereafter.
Incentives for shares held for over 5 years	50% of the capital gains can be tax-exempt should the shares be held for more than 5 years.	50% of the capital gains can be tax-exempt should the shares be held for more than 5 years.

PwC observations

At this point, it is envisaged that the MOF will likely stand firm on the proposed bill despite heated discussion from the general public and debate in the Legislative Yuan. While the MOF's primary target is retail investors with deep pockets and those who frequently trade in the TSE or OTC, this proposal could mean a bigger tax bill, increased pressure on profitability and compliance burden for the FS sector.

- Banks: For banking entities (particularly those with large offshore banking unit (OBU) operation), the increased AMT tax rate to 12 per cent means increased AMT liabilities, even if they do not transact in securities and futures/options transactions.

- Insurance and securities companies: Insurance and securities entities with proprietary businesses holding large portfolios of Taiwanese securities (and potentially futures transactions) may now need to factor in higher tax costs into their returns on investments.

- Local manufactured funds: Local manufactured funds shall remain untaxed at the fund level. For corporate investors (including foreign companies with a permanent establishment (PE) in Taiwan) of local manufactured funds, gains from trading or redemption of local funds (listed and unlisted) remain included in their AMT calculation but taxed at the increased 12 per cent AMT. As for individual investors, gains from trade or redemption of private placement local funds are now proposed to be taxed at 20 per cent under the regular income tax regime.

- FINIs: Based on the draft proposal, foreign investors without PEs in Taiwan are excluded from the proposal. Thus, capital gains from securities and futures/options transactions derived by foreign institutional investors (FINIs) without PEs in Taiwan remain untaxed.

- Cost and expenses: It is proposed that the cost base and necessary expenses may be deductible against the capital gains calculations. For necessary expenses, corporate (under AMT regime) and individual investors (under regular income tax regime) may deduct interest expenses on loans taken to finance the securities transactions from the capital gains derived. More guidance may be released once the full proposal is finalised.

- Potential increased compliance and anti-tax avoidance measures: To prevent taxpayers from evading the proposed tax on capital gains, the MOF may likely amend tax regulations with greater emphasis on substance-over-form principles, anti-tax avoidance measures, PE determination and beneficial ownership rules. The announcement so far is only an outline of the proposed tax on capital gains. Details regarding implementation steps and audit approaches are yet to be confirmed.

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

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