MERGERS & ACQUISITIONS

ASIAN TAXATION GUIDE 2002

PRICEWATERHOUSECOOPERS

FOREWORD

The year 2001 was a dismal period for the mergers and acquisitions (M&A) scene in Asia. The global economic downturn has affected M&A activities in the region. Based on figures released by Thomson Financial, announced M&A transactions in the Asia Pacific fell by a hefty 39.1 per cent to US$141.3 billion in 2001, compared with US$231.9 billion in 2000.

However, a number of developments are expected to have a positive impact on the Asian M&A landscape in 2002. Chief among these are the upbeat economic outlook in the United States and the region, and China's entry into the World Trade Organisation. Also helpful are the continued corporate and financial sector reforms in many parts of Asia, including Japan, Korea and Malaysia; consolidation in the Hong Kong wireless telecom sector; and the increasing focus on enhancing shareholder value.

Yet M&A transactions remain a risky business, particularly those involving cross-border deals where regulatory issues could make or break a deal. Research shows that one out of every two M&A deals delivers disappointing results, either because of the failure to enhance corporate performance, or market position, or shareholder value

Taxes can play a large part in adding value to the deal if managed properly, and conversely, destroy a deal if not handled with care. Proper planning can, for instance, help the parties involved take advantage of available tax concessions.

The tax regulations and practices in Asia may be complex, even to tax generalists practising in the region, not to mention investors from outside Asia. This book outlines some of the major taxation issues that purchasers and sellers will need to consider before embarking on an M&A deal in Asia. This is the second edition of the Guide and is available for the first time in CD-rom format. An expanded list of countries is covered in this Guide, containing information from 14 countries (compared with 12 in the previous Guide).

Also included in this guide are the PricewaterhouseCoopers contacts in Asia, Europe and America who can assist you with your deal wherever you or your target may be located.

Our tax consultants are deal architects who can help you add value to the deal. They will participate in the whole M&A process starting with pre-deal negotiation, due diligence, tax structuring and post-merger integration. Our aim is not only to assist our client to identify and manage the risks involved in the acquisition, but more importantly, to assist the client to identify and capitalise on the opportunities.

David Toh
Asian Leader for M&A Tax Services
PricewaterhouseCoopers

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POST DEAL INTEGRATION™ (PDI)

An important factor in the success of a deal, be it a merger, acquisition or buyout, is the prompt implementation of the business strategy immediately after the transaction is sealed. However, this process is often chaotic, with groups often losing control of their tax position. A failure to align tax strategy with business strategy and a lack of clear decision-making on tax issues will delay successful integration and will mean missed opportunities for optimising the group's tax position.

PricewaterhouseCoopers' global M&A specialists have developed a methodology called Post Deal Integration (PDI) to assist our clients in overcoming these problems.

Risks and opportunities

There are a number of integration risks that may result from a deal. Tax costs may arise when business structures are being reorganised. These could be caused by the transfer of taxable values between entities or countries, or through the loss of tax attributes such as deduction for losses.

Risks can also arise from the lack of information, the disruption of processes and unclear decision making. These need to be recognised and managed.

PwC's PDI™ approach can help organisations to avoid such pitfalls, and maximise the tax advantages of a deal through identifying important tax issues, prioritising them and mapping out a focused workplan to implement various projects. Indeed, mergers and acquisitions create unique opportunities for tax structuring and optimising the enlarged group's tax profile. Solutions that would be intrusive for an existing business will be less so when a new organisation is created. A key opportunity is created by the existence of a commercial rationale for any tax restructuring.

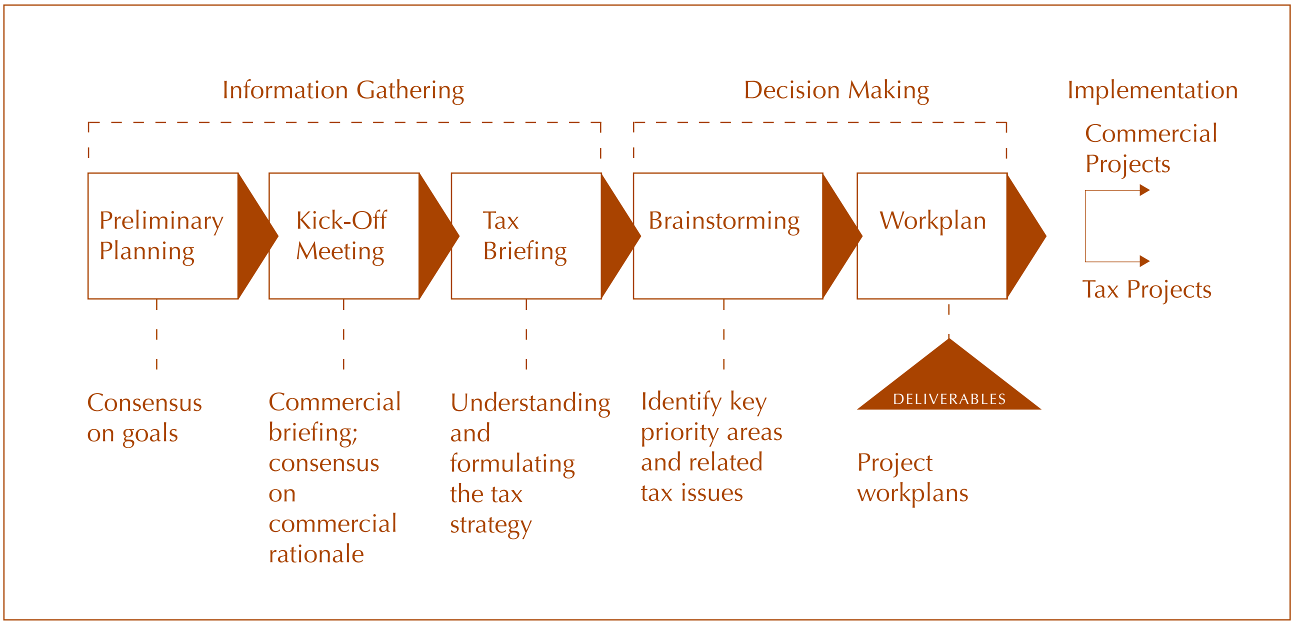
PDI can help organisations to address conflicting approaches of the legacy groups of companies, for, no matter how effective the tax strategies were for the groups prior to their merger, these are almost certain to be inappropriate for the new combined group.

PwC Approach

PDI is a systematic, robust process to capture quickly the best solutions at the crucial period immediately after a deal is sealed by delivering focused output in the first weeks of integration.

The key stages are diagrammatically illustrated below.

Post Deal Integration: Overall approach



This approach ensures that the relevant information is gathered, and priorities and values are identified. The prioritisation will consider both the risks and cost vis-a-vis financial rewards. The final stage is to deliver a focused workplan. The outcome from the work plan will be various tax saving measures to be implemented alongside the business and management integration.

The process is scaleable depending on the complexity and the size of the deal.

Where a robust process is in place, the chances of success increase. Past researches have shown the most common mistake made in the deal environment is lack of implementation. Our proven process helps avoid this and therefore adds value.

PDI can assist the enlarged group to

- maintain control of key tax areas during the transitional period, hence reducing tax risk;
- focus resources on quick wins, bringing immediate tax benefits and key strategic changes which have a major impact on the group effective tax rate;
- develop a longer term tax strategy which takes advantage of business change to optimise the group tax position over the medium term; and
- ensure that tax strategies contribute to the success of the deal.

The success of a deal does not end with the signing of the sale and purchase agreement. It is judged by the value that can be harvested from the enlarged group. Tax savings can contribute significant to the after-tax profit and thus impact greatly on shareholder value. Our PDI team, working closely with the post-deal services team from our Transaction Services unit, can help a merged group achieve such important milestone.

AUSTRALIA

Country M&A Team

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GENERAL INFORMATION

(i) Introduction

The Australian taxation system is going through a period of significant change. The Government has launched various taxation initiatives in recent years, including:

- complex tax reform measures which follow a review of business taxation;
- the rewrite of the entire Income Tax Assessment Act into plain English;
- the introduction of a goods and services tax (GST) from 1 July 2000; and
- the introduction of the new debt/equity and thin capitalisation regime from 1 July 2001.

The Government is also on the verge of introducing a new consolidations regime which will treat groups of wholly owned Australian companies as a single tax entity. These rules are expected to apply from 1 July 2002.

These initiatives have created a complicated tax landscape for structuring M&A transactions. However, there are still many opportunities to structure an M&A transaction in a manner which delivers significant value to both the vendor and purchaser – particularly in terms of capital gains tax planning, and optimising funding and repatriation arrangements.

There is no legal concept of a merger in Australia as it exists in other countries. An effective merger can arise by acquiring the target company and then liquidating that company and transferring its assets to the acquisition vehicle.

This can generally be achieved without any income tax or capital gains tax, where the target company is 100% owned by the acquisition company. However, the transfer of property from the target company to the acquisition company may be subject to stamp duty (at rates of up to 5.5%). Various exemptions from such stamp duty exist in some states, and therefore the ultimate stamp duty liability will depend on the location of the assets.

A cross-border merger can also be achieved in a similar way, though the relief from income tax, capital gains tax and stamp duty is not likely to be available and therefore there will be a more significant tax cost.

(ii) Common Forms of Business Entity

a) Corporation

The corporation is the most common form of business enterprise in Australia. Corporations are flexible investment vehicles regulated by federal corporations legislation. They are a legal entity distinct from its shareholders, and are taxed as a separate entity.

b) Partnerships and Trusts

Partnerships and trusts are currently both flow through entities for tax purposes.

c) Unincorporated Joint Ventures

Unincorporated joint ventures are simply a contractual association between two or more parties, and are sometimes used where parties wish to share in the output of a venture rather than to receive income jointly.

d) Branches

An Australian branch of a foreign corporation is sometimes used where an investment is likely to incur losses in the early years. It is currently not regarded as a separate entity for tax purposes. Although there has been some movement towards aligning the tax treatment of branches with companies as part of the tax reform process, no changes have been introduced to date.

(iii) Foreign Ownership Restrictions

Australia has very few sectors where foreign investment is restricted. Foreign investment in media, the big four Australian banks and domestic airlines are some examples where restrictions apply.

The government administers its foreign investment policy through the Foreign Investment Review Board (FIRB). In general terms, all foreign investment proposals must be submitted to the FIRB for approval, unless they are exempt. Exempt proposals include a portfolio (less than 15%) investment in a public or private company, or where the value of the target Australian business is less than $50m.

However, foreign investors may, in most instances, expect approval within 30 days. Only around 2% of proposals are ultimately rejected by the FIRB.

(iv) Tax Rates

a) Corporate Tax

The corporate tax rate in Australia was reduced from 34% to 30% from 1 July 2001.

b) Withholding Tax

Interest, dividends and royalties paid to non-residents are subject to Australian withholding tax, which is a final Australian tax for these non-residents. The rates of tax vary depending on whether Australia has a double tax agreement (DTA) with the recipient jurisdiction. In summary, the rates are usually as follows:

	Non Treaty Rate %	Treaty Rate %
Interest	10	10
Royalties	30	10 - 15
Unfranked dividends (paid out of untaxed profits)	30	15
Franked dividends (paid out of taxed profits)	Nil	Nil

c) Fees for Service

Fees for service are not currently subject to withholding tax, provided they are not considered royalties. One tax reform initiative announced is the introduction of a new, broader withholding tax for all Australian sourced income paid offshore. However, no legislation has been introduced to date.

d) Branch Profits Tax

There are currently no taxes on the remittance of branch profits to the foreign parent.

However, Australia has a peculiar law which seeks to levy tax on dividends paid by non-residents which are sourced from Australian profits. This means that if a foreign company on-pays the Australian branch profits to its foreign shareholders as a dividend, the shareholder is technically liable to Australian tax (limited to any DTA rate which may be applicable). However, the Taxation Office has jurisdictional difficulties in collecting this liability.

(v) Taxation of Dividends

Dividends paid to Australian resident companies are fully taxable at the corporate rate, subject to the following concessions:

- *Franked dividends between Australian companies are fully rebateable. A rebate is a tax credit equal to the imputed tax attached to the franked dividend.*
- *Unfranked dividends paid between 100% Australian group companies are also fully rebateable provided they have been members of the same group for the entire year of income. Unfranked dividends between non-group companies are no longer rebateable from 1 July 2000, and are therefore, in effect, fully taxable to recipient companies.*
- *Non-portfolio dividends received from foreign investments are typically exempt from tax where the foreign income has in essence been comparably taxed. The recipient must own more than 10% of the foreign corporation to obtain this exemption.*

Australia has a conduit regime for dividends flowing through Australia to a foreign parent. Qualifying foreign source dividend income received from foreign investments are credited to a Foreign Dividend Account (expected to be expanded from 1 July 2002 to include all foreign income). Dividends on-paid to foreign shareholders out of this account are withholding tax free.

(vi) Tax Losses, Capital Losses and Foreign Losses

Unlimited carry forward applies to losses incurred in 1989-90 and subsequent years, although losses cannot be carried back. However, there must be a continuity of ownership (of more than 50%) or a continuity of the same business in order to obtain a deduction for losses incurred in the past or in any part of the current year. Specific complex rules apply to losses carried forward by trusts.

Losses (tax and capital) can be transferred between 100% Australian group companies provided the companies were also members of the group when the loss was incurred. A prior year loss may be transferred in a later year or a loss may be transferred in the same year it is incurred.

It has been proposed that a consolidation regime be introduced from 1 July 2002. This is expected to impact significantly upon the manner and order in which losses may be utilised going forward.

Capital losses are only available against future capital gains.

Foreign losses have historically been quarantined against foreign income arising in specific classes. However, this restriction has been lifted from 1 July 2001 with respect to debt deductions incurred in deriving certain foreign income.

(vii) Thin Capitalisation and the Debt Equity Regime

a) *Thin Capitalisation Regime*

A key component of the Business Tax Reform package was the introduction of a completely new thin capitalisation regime which potentially restricts the amount of tax deductible debt which any multinational (whether Australian or foreign based) can allocate to its Australian operations. Allied to this measure is a redraft of the tax distinction between debt and equity.

The new thin capitalisation rules apply from the taxpayer's first income year beginning after 30 June 2001. Broadly, the new rules (as they apply to non-banks) will extend the thin capitalisation rules to include the Australian operations of both inbound (foreign entities investing in Australia) and outbound (Australian entities with controlled foreign investments) investors. Previously, the rules only applied to inbound investors.

Importantly, the new rules will limit tax deductions relating to total debt of the Australian operations. Previously the rules only applied to related party foreign debt.

A 'safe harbour' level of total debt of 75% of Australian assets will be available. An alternative arm's length test requires the taxpayer to demonstrate that the gearing level could have been borne by an independent entity. A further test for outward investing entities only is based on 120% of their worldwide debt.

Modified rules apply to (non-bank) financial institutions, Australian banks and Australian branches of foreign banks.

b) *Debt Equity Regime*

All companies, regardless of whether the thin capitalisation rules apply to them, need to distinguish between 'debt interests' and 'equity interests', because from 1 July 2001, distributions may have different tax implications depending on the classification of the underlying instrument.

The distinction between debt and equity is based on a substance over form approach. This means that legal form debt may be treated as equity, and legal form equity may be debt for Australian tax purposes.

Under these new rules an instrument will be classified as debt, rather than equity, if there is an effectively non-contingent obligation for the issuer to return the initial outlay (i.e. the original investment) to an investor. In general terms, returns on interests classified as debt are deductible and cannot have dividend franking credits attached.

An equity interest will generally be characterised by returns that are contingent on the economic performance of the issuer. Returns on equity are non-deductible but generally can have dividend franking credits attached.

Under these rules, hybrid (part debt/part equity) instruments will be classified as either all debt or all equity.

Following the introduction of these new rules, particular care will need to be taken when considering how the acquisition of Australian assets will be funded. For example, where the acquisition is to be partly funded by shareholder loans, there is a risk that the related arrangement provisions may apply to deem the shareholder loans to be non-share equity. Unforseen tax consequences may therefore result absent any planning.

(viii) Other Taxes

A broad based goods and services tax (GST) was introduced from 1 July 2000, replacing the former sales tax regime. The GST rate is currently 10%.

Other taxes include state taxes such as stamp duty on the conveyance of property (eg. 0.6% on the acquisition of private company shares), Fringe Benefits Tax (a tax on the employer) at 48.5% applicable to non-cash benefits provided to employees, payroll tax paid by employers, land tax and bank account debits tax.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profits on Sale of Shares

A seller's main concern will be capital gains tax upon the disposal of its shares. Capital gains tax (CGT) generally applies to the disposal of shares acquired on or after 20 September 1985. Individuals who have held shares for more than 12 months may be entitled to a 50% CGT discount when calculating their taxable income. There is no stamp duty applicable to a seller.

Commercially, a seller may prefer to sell shares so as to not be left with a structure requiring liquidation or ongoing maintenance.

Scrip for Scrip

Scrip for scrip provisions provide rollover relief from capital gains tax, thereby allowing a seller to defer any capital gains tax liability where consideration for the sale is shares in the acquiring entity. This allows takeovers or mergers to occur without an immediate tax liability to the vendor.

To obtain scrip for scrip relief, the acquiring entity must acquire at least 80% of the voting shares in the target entity and issue scrip in return. The provisions are complex, and in a cross-border context, are limited in scope, broadly to widely held entities.

Distribution of Profits

Dividends paid offshore are subject to withholding tax unless they are franked (paid from after tax profits). No further tax is payable on repatriated franked or unfranked dividends.

See (ii)(f) below regarding 'Repatriation of Profits' for comments on a capital return.

Shareholder Loans

Care needs to be taken when the Target company has debts due to overseas related parties which are unlikely to be repaid prior to the completion of the sale.

If the debts are simply forgiven the Australian debt forgiveness rules may operate to deny the future utilisation of certain tax attributes of the target company (e.g. carried forward tax losses – both revenue and capital – and the tax base of certain depreciable and capital assets). Similar issues may arise if the outstanding debt is capitalised.

A commonly adopted alternative is to adjust the final purchase price by the amount of the outstanding debt.

Unwanted Assets

Assets held by the target company which are not to be included within the sale may be transferred to other members of the vendor's wholly-owned group without giving rise to an immediate tax liability. However, a tax liability may crystallise if the transferred asset subsequently leaves the vendor's group. This is therefore a factor to consider on any future reorganisation of the vendor's group.

(ii) Buyer's Perspective

a) Acquisition Structure

A non-resident buyer may be concerned with structuring a share acquisition to avoid a capital gain on future disposals. This frequently involves setting up an acquisition subsidiary in a favourable non-resident jurisdiction. Selling the non-resident holding company or accessing DTA relief on the sale of the Australian company may then mitigate capital gains tax (see Exit Route). These strategies are now subject to potential change under tax reform proposals, and anti-avoidance considerations.

b) Funding Cost

Purchasers will typically use a mixture of debt and equity to fund an acquisition.
For non-residents, maximising debt has several advantages. Interest paid offshore is only subject to 10% withholding tax, but is deductible in Australia at 30% (subject to thin capitalisation constraints). Repayment of debt principal is also an effective method of repatriating surplus cash without a withholding tax or capital gains tax cost.

Australia currently does not have a consolidation regime, although losses and assets can be transferred by election between 100% group companies. This allows a non-resident to use an Australian holding vehicle if desired. Interest deductions incurred in that entity can be transferred to the target.

If an Australian holding company is used to fund the acquisition, consideration needs to be given to how the debt will be serviced. Dividends from the target will absorb tax losses in the holding company, and the dividend rebate otherwise available will be lost. Instead, cash should be transferred from the target to the holding company by way of interest free loan or tax free subvention payment for the losses to service the debt.

It is proposed that a consolidation regime will be introduced from 1 July 2002. This will mean that acquisition structuring should become simpler with intra-group dividends ignored for tax purposes.

c) Acquisition Expenses

Acquisition expenses are typically non-deductible, but form part of the capital cost base for calculating profit on future disposals and for calculating depreciation on depreciable assets. This includes acquisition stamp duty.

However, the introduction of a new uniform capital allowances regime now means that costs of unsuccessful takeover attempts may now be deductible as well as other business related costs (that traditionally have not been deductible).

Costs of borrowing other than interest or principal payments (eg. merchant bank fees) are deductible over 5 years, or over the life of the loan if shorter than 5 years.

d) Debt/Equity Requirements

See paragraph (vii) above regarding Thin Capitalisation, under the section 'General Introduction'.

e) Preservation of Tax Losses and Other Tax Incentives

Tax Losses

Once there has been a change in the ownership of the target by more than 50%, carry forward losses can only be utilised if the target carries on the same business post the change of ownership. The Australian Taxation Office is reasonably strict on what constitutes the same business.

Even if the same business test is satisfied, the losses in the target cannot be transferred to new group companies. That is, purchasers with existing Australian operations cannot use losses in acquired entities to shelter profits in their existing group.

Tax Incentives

There are few tax incentives for purchasers of Australian shares. Proposals aiming to promote investment in innovative Australian firms provide for an extension of the previously announced exemption for capital gains realised by certain investors in venture capital investments, by providing venture capital limited partnerships flow through tax treatment. These changes are expected to apply from 1 July 2002.

Other significant tax incentives/grants provided in Australia include:

- an outright deduction for capital expenditure incurred in the Australian film industry;
- an outright deduction for certain relocation costs incurred in establishing a regional headquarters;
- Export Market Development Grant (EMDG) program which provides funding for up to $200,000 for expenditure in the development of eligible export markets; and
- a 125% deduction (increased to 175% for certain qualifying companies) for eligible research and development expenditure.

f) Repatriation of Profits

Dividends

Dividends paid offshore are subject to withholding tax unless they are franked. No further tax is payable on repatriated franked or unfranked dividends.

Interest and Royalties

Interest and royalties are common and efficient methods of repatriating profits, because they are typically deductible in Australia. The withholding tax cost is usually lower than the corporate tax saved.

Strategies to repatriate profits using interest or royalties will need to take into account thin capitalisation constraints for interest, and transfer pricing provisions generally. Australia's transfer pricing regime is broadly consistent with OECD guidelines, but comparatively strict and effectively policed by the ATO.

Capital Return

A capital return is not assessable to a non-resident where the shares in question do not cease to exist, although the distribution of capital will cause the shares in the Australian entity to be rebased downwards for capital gains tax purposes. To the extent the distribution exceeds the cost base, a capital gain will occur.

Share buybacks can also be an effective method to return capital, although a deemed dividend component would often arise.

Government Approval Requirements

Australia requires each currency transaction over $10,000, including international telegraphic and electronic transfers, to be reported to the Australian Transaction Reports and Analysis Center. However, this is not an approval requirement, merely a notification issue.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

a) Profits on Sale of Assets

As for shares, a seller's main concern will be capital gains tax upon the disposal of its assets. In addition, the sale of depreciable assets could result in a clawback of depreciation to the extent the asset is sold above its tax written down value.

Unwinding, liquidating or maintaining the structure post sale has commercial complications which a vendor may wish to avoid.

b) Distribution of Profits

Again, dividends paid offshore are subject to withholding tax unless they are franked (paid from after tax profits). No further tax is payable on repatriated franked or unfranked dividends.

See 'Repatriation of Profits' for comments on a capital return, under section 'Structuring a Share Deal'.

(ii) Buyer's Perspective

Traditionally, there has been a preference in Australia for purchasers to acquire assets rather than shares. The acquisition of assets has several advantages above the acquisition of shares, including:

- Freedom from any exposure to undisclosed tax liabilities.
- The tax effective allocation of purchase price, which may enable a step up in basis for depreciable assets and deductions for trading stock.
- Valuable trademarks or other intangibles may be acquired and located outside Australia. This would enable the licensing of the intangible to the Australian company, thereby generating allowable deductions to reduce overall Australian tax.
- Provides an opportunity for tax effective employee termination payments.

Disadvantages of an asset purchase include that any losses or franking credits of the vendor will not flow to the purchaser, and generally stamp duty on the acquisition of a business can be as high as 5.5%. This is significantly higher than the stamp duty on a private company share purchase of 0.6% (assuming that the company is not land rich). Stamp duty is a state based tax and varies from jurisdiction to jurisdiction within Australia.

a) *Acquisition Structure*

Similar structuring issues apply to the acquisition of assets as for shares. If the assets are held directly by an offshore entity, the assets will nevertheless form part of the Australian capital gains tax net in relation to future disposals if they have a necessary connection with Australia. Accordingly, setting up a foreign holding jurisdiction to minimise CGT on exit continues to be relevant in the context of an asset acquisition.

Funding issues, loss transfers, thin capitalisation and other structuring issues are the same as between assets and shares.

b) *Debt Deductions*

Funding costs (interest) are typically deductible, subject to thin capitalisation constraints. General restrictions on deducting interest where the debt is used to acquire foreign assets, or debt has been created upon the acquisition of an asset from a foreign controller have been lifted from 1 July 2001.

Other expenses of borrowing such as bank fees will generally be deductible over 5 years, or the life of the loan if less than 5 years.

c) *Acquisition Expense*

See comments on Acquisition Expenses under the section 'Structuring a Share Deal'.

d) *Cost Base Step-Up*

Where parties are not acting at arm's length, the cost base of an asset will be the market price negotiated between them. A buyer will typically try to allocate purchase price to depreciable assets rather than goodwill in order to step up the cost base and maximise deductions post acquisition.

There are more aggressive techniques available to step up the cost base of an asset to market value prior to sale, but these must have due consideration to general anti-avoidance rules.

Non deductible expenses of acquisition or sale can be included in the cost base of an asset.

e) *Treatment of Goodwill*

Under current taxation laws, there are no deductions available for the acquisition of goodwill.

New capital allowance provisions will provide for amortisation deductions for certain types of intangible property. While this will not extend to goodwill, a purchaser might be able to structure an asset acquisition in a manner where prescribed intangibles are acquired rather than goodwill, for example, allocating purchase price to a licence to obtain amortisation deductions.

f) *Other matters*

Claiming a GST Refund

The acquisition of a going concern will be exempt from GST. To the extent GST is payable, the GST should be allowed as an input tax credit against any GST collected by the entity. Excess GST credits are fully refundable by the Taxation Office to a qualifying entity.

Repatriation of Profits

If the assets are acquired directly by the foreign entity (i.e. through an Australian branch), no branch profits tax will apply on cash paid offshore.

Assets acquired by an Australian acquisition entity will have similar repatriation issues as described above for shares.

EXIT ROUTE

Certain structures can be put in place to ensure that the capital gains tax on the ultimate sale of shares or assets is minimised.

(i) Treaty Protection

There are good arguments that suggest that the disposal of shares by companies resident in certain countries are protected from Australian capital gains tax under that country's DTA with Australia. The strongest DTA protection is available from Belgium, Switzerland, Sweden, Denmark and Norway.

(ii) Tax Havens

A foreign acquirer can set up a subsidiary in a tax haven to acquire Australian shares or assets. When the Australian investment is to be sold, the tax haven company can be sold instead. Under current rules, no Australian capital gains tax liability arises to the vendor (although the purchaser receives an asset pregnant with a future tax liability). However, tax reform tracing proposals, if enacted, may remove this option.

ENDING REMARKS - PREPARATION FOR A DEAL

(i) Seller's Perspective

To minimise or defer tax on sale, a seller should consider selling shares in exchange for scrip under rollover, or selling shares in order to access DTA relief where possible. Cost base step up strategies could also be considered, but these should have due regard to general anti-avoidance provisions.

(ii) Buyer's Perspective

A buyer should consider a sensible international structure which takes into account future exit and repatriation issues, and how to push down debt into Australia as part of the acquisition. Interest double dip structures may also be available depending on the home jurisdiction. Acquiring assets rather than shares may also maximise deductions post acquisition (i.e. depreciable assets rather than goodwill). Acquiring shares in exchange for scrip may enable a merger without cashflow constraints.

CHINA

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GENERAL INFORMATION

(i) Introduction

After nearly 15 years of negotiation, China's accession to the World Trade Organisation (WTO) finally became a reality on 11 December 2001. The accession has had a significant impact on China foreign trade and investment policies. Tariff reductions, removal of non-tariff barriers and relaxation of many of the current restrictions over foreign investment, albeit on a gradual basis, have unleashed significant opportunities and challenges to both the current players and new comers.

Mergers and acquisitions are one of the quickest ways for new and existing foreign investors to expand their market share in post-WTO China. Domestic players are also expected to engage in significant merger and acquisition activities as they scramble for market share and improve operational and cost efficiency.

This article highlights the existing China tax issues that foreign investors typically encounter when investing into China. It should be noted that mergers and acquisitions by domestic enterprises are governed by a different set of tax rules and regulations which are not covered here.

(ii) Common Forms of Business Entity

The Chinese Government has introduced various measures to attract foreign investments, particularly in priority industries where imported advanced technology, equipment and know-how are most needed for the modernisation of the Chinese economy. According to China's own state of development, foreign investment projects are classified into the 'Encouraged', 'Restricted', 'Permitted' and 'Prohibited' categories that will have a bearing on matters such as the required form of entity in China (i.e. a joint venture or a wholly foreign-owned enterprise), tax incentives, approval procedures and degree of foreign participation (i.e. prohibited, minority or no limitation on foreign equity interest).

Currently, the common forms of foreign investment in China are:

- Processing trade contracted with domestic enterprises and State Owned Enterprises;
- Equity or contractual joint ventures; *
- Wholly foreign-owned enterprises; *
- China Investment Holding Companies (CIHC) which are primarily the holding vehicles for Foreign Investment Enterprises (FIEs) that perform investment, management and other permitted business functions within China;
- Foreign Investment Companies Limited by Shares (FICLS) whereby the companies may list their shares on a stock exchange in China.

** Collectively known as Foreign Investment Enterprises (FIE)*

Capital contribution can be made in cash or in-kind. In order for an enterprise to be classified as an FIE, the capital contribution by foreign investors should represent at least 25% of the total investment. FIEs are required to observe the debt/equity ratio stipulated in the investment regulations as follows:

Total investment (US$)	Minimum Registered Capital (US$)
Less than 3 million	70% of the total investment
Between 3 and 10 million	Higher of 2.1 million or 50% of the total investment
Between 10 and 30 million	Higher of 5 million or 40% of the total investment
More than 30 million	Higher of 12 million or 1/3 of the total investment

(iii) Foreign Ownership Restrictions

As indicated above, permitted foreign investment projects are classified into the 'Encouraged', 'Restricted', 'Permitted' and 'Prohibited' categories. Foreign investors should enquire as to the appropriate categories of their investments before embarking on an merger and acquisition deal in China.

(iv) Tax Rates

a) Income Tax

Under the current China tax regulations, a standard income tax rate of 33% (which includes a 3% local tax) generally applies to FIE and foreign enterprises. Tax incentives in the form of tax holiday and reduced tax rates are available for qualifying projects in China.

FIE

In order to encourage foreign investment, China offers various preferential tax treatments to FIEs in designated regions and industries.

(a) *In the Form of Income Tax Holiday*

FIEs classified as productive in nature with an operating period of over 10 years are entitled to two-year exemption from income tax followed by a three-year 50% reduction in income tax rate, starting from the first profit making year after utilising the available tax loss brought forward.

Productive FIEs that qualify as export-oriented enterprises for which the value of exported products of a year exceeds 70% of the total value of output of the year may continue to enjoy a 50% reduction in the applicable income tax rate after the expiration of normal tax holiday, subject to a 10% minimum rate.

Productive FIEs that qualify as technological advanced enterprises can enjoy a 50% reduction in tax rate for an additional three-year period after the expiration of normal tax holiday. Again, the reduced tax rate may not be reduced to below 10%.

Tax loss of an FIE may be carried forward for a maximum period of 5 years. The tax loss, however, cannot be carried backward to offset against profits in prior years.

FIEs located in designated areas and engaged in certain encouraged projects are entitled to certain reduced tax rates and extended tax holidays as defined by the tax regulations.

(b) *In the Form of Reduced Tax Rate*

FIEs located in the following designated areas are eligible for reduced income tax rate of 24% or 15%, depending on the location and/or type of business of the FIE:

- Special Economic Zone;
- Coastal Open Economic Area;
- Economic and Technological Development Zone;
- High and New Technology Development Zone;
- Remote and Economically Under-developed Rural Area;
- Central Western part of China.

(c) *Others*

Foreign investors are eligible for income tax refund on direct reinvestment of profits derived from the FIE, provided that the profits are reinvested into the same or another FIE.

- *Withholding Tax*

  Foreign enterprises that do not have establishments or places of business in China but derive China sourced income, for example, interest, rental, royalties, capital gains on transfer of real estate properties and gains on a disposal of equity interest in FIEs, would be subject to China withholding income tax at the general rate of 20% which has provisionally been reduced to 10%, starting 1 January 2000. The withholding income tax rate may be further reduced if the foreign enterprise is a tax resident of a country which has concluded an income tax treaty with China and such treaty provides for such a reduction.

  Dividends paid by FIE to foreign investors are not subject to any withholding income tax.

  Foreign enterprises may also be subject to other taxes if they generate income sourced in China or conduct activities in China, which fall within such scope of charge.

(v) Taxation of Dividends

Dividend distribution from FIEs to their foreign investors are exempted from China withholding income tax. Likewise, interest cost incurred on debt used to finance the investment is not deductible.

(vi) Tax Losses

As indicated above, tax losses of an FIE may be carried forward for a maximum period of 5 years irrespective of whether there is a change in ownership of the FIE. Tax losses may not be carried backward.

(vii) Impending Changes to the PRC Income Tax System

China will be undergoing income tax reform under which a unified income tax law for FIEs and domestic enterprises will be promulgated. Significant changes are expected to be introduced to the current tax incentive policy. It is expected that in the future, income tax incentives might only be offered on industry-specific basis rather than on geographical basis, except in the designated Western and Central China region.

(viii) Thin Capitalisation

As indicated above, FIEs are required to observe the debt/equity ratio stipulated in the investment regulations (see paragraph (ii) above – 'Common Forms of Business Entity').

(ix) Other Taxes

Apart from income tax, FIEs are subject to various other taxes in China as summarised below.

Tax	*Tax Rate (%)*	*Scope of charge*
Value-Added Tax (VAT)	Generally 13 or 17[(1)]	Sale and importation of goods and provision of processing and repair services
Business Tax	3 - 20	Provision of taxable services and transfer of intangible and immovable properties
Consumption Tax	3 - 45[(2)]	Manufacturing, processing and importation of taxable goods
Stamp Tax	0.005 - 0.1	Dutiable documents concluded or executed in China
Land-Value Appreciation Tax	30 - 60	Gain on disposal of land-use rights and buildings
Deed Tax	3 - 5	Purchase of land-use rights and real estate properties
Real Estate Tax	1.2 or 18[(3)]	Ownership of real property interests

Notes: [(1)] 4% or 6% may be applicable to small-scale taxpayer. Export is generally subject to Exempt, Credit and Refund method in calculating VAT.
[(2)] Some dutiable goods are subject to consumption tax at a fixed amount based on the volume concerned.
[(3)] Depending on whether the cost or rental value of the property is adopted in calculating the Real Estate Tax.

STRUCTURING A SHARE DEAL

Under a typical share deal model, the foreign investor acquires the equity interest of the Chinese target company from the seller (direct disposition), or acquire the shares of the foreign company that holds the Chinese target company (indirect disposition). The target company in China will remain as a going concern subject to the conditions granted by the relevant Chinese authorities when the target was set up.

(i) Seller's Perspective

a) Profit on Sale of Equity Interest

Under a direct disposition, capital gain realised by the foreign seller is subject to China withholding income tax of 20% which has provisionally been reduced to 10% starting 1 January 2000. The withholding income tax rate may be further reduced if the foreign seller is a tax resident of a country which has concluded an income tax treaty with China and the tax treaty in question provides such a reduction. The capital gain is the transfer consideration received in excess of cost of equity interest. Transfer consideration includes both cash and non-cash benefits received, after deduction of the seller's share of undistributed profits and statutory after-tax reserve funds set aside by the target company. Cost of equity interest represents the capital previously contributed into the target company by the seller or its acquisition cost of the equity interest in the target company.

In general, the transfer consideration should be set at fair market value with the exception where the transfer of equity interest is made in pursuance of an internal reorganisation. In such a case, the cost of equity and the pro-rata share of undistributed profits and after-tax reserves could be adopted as the transfer consideration.

However, if the seller is a tax resident of a country (e.g. Mauritius, Korea and Switzerland) that has entered into a tax treaty with China which provides exemption from Chinese tax on such capital gains, the gain would not be subject to any Chinese tax unless the assets of the target company consist principally of immovable property situated in China.

Transfer of equity interest in a Chinese entity is subject to stamp tax at the rate of 0.05% on the transfer price payable by each contracting party.

Moreover, business tax of 5% on the transfer consideration would be payable if the seller has previously contributed immovable properties or intangible assets into the target company.

An indirect disposition involves a transfer of equity interest of a foreign entity and thus should not attract Chinese taxes.

(ii) Buyer's Perspective

a) Acquisition Structure

Under a typical share deal model, a buyer would use an offshore investment holding vehicle to acquire the Chinese target company. This is largely due to the fact that foreign companies cannot establish special purpose holding companies in China easily. The countries which are commonly used to set up an offshore investment holding vehicles include Hong Kong, Mauritius and the British Virgin Islands.

Holding companies (CIHC) in China are typically used by strategic investors with multiple investment projects or FIEs in China. The approval conditions for such a holding company are stringent and are as follows:

1) The foreign investor should have good reputation, creditability and financial strength;
2) The minimum registered capital of a CIHC is US$30 million;
3) The paid-up capital of the foreign investor's existing investment in China should not be less than US$10 million in aggregate;
4) The total assets of the foreign investor in the preceding year should not be less than US$400 million; and
5) The foreign investor should have more than three proposed investments approved by the Chinese authorities; or
6) If items 3, 4 and 5 above are not satisfied, the foreign investor should have established 10 or more FIEs in China that are engaged in manufacturing or infrastructure business and the total paid-up capital of these FIEs should be greater than US$30 million.

CIHC is generally subject to income tax at 33%, except for CIHC established in the Special Economic Zones. Since dividend income earned from FIEs is exempted from income tax, a CIHC cannot claim tax deduction for the following expenses and losses relating to its investments:

- feasibility study expenses;
- interest payment on borrowings for financing the investments;
- investment management expenses and expenses incurred in the course of deciding on such investment; and
- irrecoverable investment losses upon expiry of the investment period.

Under a share deal structure, there is no change in the legal existence nor disruption to the tax attributes of the acquired entity. Thus, the target company cannot re-value its asset basis for Chinese tax purposes.

b) Funding Cost

As indicated above, dividends received by an investor is not subject to any Chinese tax and the cost of fund used to acquire the equity interest is not tax deductible.

Accordingly, a buyer may need to structure the acquisition in such a way that the cost of funds may be tax deductible in a country other than China.

c) Acquisition Expenses

Transfer of equity interest in a Chinese entity is subject to stamp duty at the rate of 0.05% of the transfer price. Such duty is payable by both the buyer and seller.

All acquisition expenses incurred by the buyer may not be allocated to the target company and therefore may not be claimed as a tax deduction in China.

STRUCTURING AN ASSET DEAL

A typical asset deal model involves the formation of a new FIE or the use of an existing FIE to acquire the selected assets, liabilities and commercial operations of the target business.

(i) Seller's Perspective

Any gain or loss derived from the sale of tangible and intangible assets will be taxable/deductible for Chinese income tax purposes.

Transfer of assets within China attracts Chinese turnover taxes. Business tax of 5% is imposed on the seller on transfer of immovable properties and intangible assets such as land-use rights, trademark, patent, copyright, goodwill and unpatented technology. VAT of 17% is imposed on inventory sold. Disposal of used equipment is in general exempt from VAT if it is sold at a value not exceeding the original cost. However, the sale of used boat, motor vehicle and motorcycle will attract VAT at 6%.

Gain derived by the seller from transfer of land-use rights and buildings in China triggers land-value appreciation tax with applicable tax rates ranging from 30% to 60%. The disposal of duty-free imported equipment within the customs supervision period would result in "claw back" of the customs duty and VAT exemption benefits granted upon importation of the equipment concerned based on a pro-ration formula.

Property transfer agreements are subject to stamp tax at the rate of 0.05% on the total contract sum. Purchase and sales of inventory is subject to stamp tax of 0.03%.

(ii) Buyer's Perspective

Buyers are subject to stamp tax at 0.05% on the total contract sum of the property transfer agreement and at 0.03% on the inventory purchase contract. Purchase of land-use right and real estate properties would be subject to deed tax ranging from 3% to 5% on the transfer price.

The asset deal model is commonly used in China when a Chinese partner injects its business into the joint venture. In other situations, rather than effecting a share deal, foreign investors may prefer to form new FIEs to take over the business operations so as to minimise their exposures to any inherent tax and business risks, hidden or contingent, that may be associated with the target company. Nevertheless, if customs duty is delinquent on the original importation or upon transfer of assets by the seller, the buyer could still inherit the tax risk associated with the assets transferred.

An asset deal model would facilitate a 'step-up' in the asset value that is eligible for depreciation or amortization charges for China income tax purpose. In case the fair market value of individual assets cannot be determined, the premium (representing the actual transfer consideration in excess of the aggregated net book value of the assets acquired) may be recorded as acquisition goodwill. The acquisition goodwill is generally amortised and deductible for income tax purposes over a minimum period of 10 years.

EXIT ROUTE

(i) Profit Repatriation

Foreign investors can repatriate profits from FIEs or CIHCs in the form of dividend if all prior years' losses have been made up and the required contributions to the statutory after-tax reserve funds have been made. Moreover, all relevant taxes should have been duly settled with the Chinese tax authorities and the registered capital should have been fully injected into the FIEs according to the prescribed timetable.

(ii) Exit Route

Foreign investors are generally not allowed to repatriate their registered capital in FIEs until the termination or liquidation of the FIEs. Capital reduction may be permitted under very special circumstances such as there exist a genuine need to reduce total investment and scale of operation of the contractual joint venture, upon government approval.

Foreign investors can acquire, reduce or dispose their investments in FIEs in the form of merger, spin-off, asset transfer and transfer of equity interest. The related Chinese tax implications under a share deal and an asset deal model have already been set out under 'Seller's Perspective' in the sections, 'Structuring a Share Deal' and 'Structuring an Asset Deal'.

It is possible for a FICLS to list its shares in China. Such form of investment vehicle, however, is not commonly adopted by foreign investors for the time being.

ENDING REMARKS - PREPARATION FOR A DEAL

(i) Seller's Perspective

Disposition of investments in China involves complicated Chinese regulatory, legal and tax considerations. Approvals from the Chinese partners and the relevant Chinese authorities are required for any change of shareholdings in foreign-invested and domestic target companies.

Depending on the investment objectives and exit strategies, the seller should consider the need to re-organise the underlying target companies in order to facilitate the disposition as tax-efficient as possible.

Furthermore, the seller needs o assess the income tax and other transactional tax costs that may arise in the disposition. Proper planning and tax-efficient structuring are often possible prior to entering into a deal in reducing the Chinese transactional tax costs.

(ii) Buyer's Perspective

The adoption of an asset deal or a share deal for an acquisition in China largely depends on the regulatory situations, as well as the commercial and tax objectives of the investors. Whilst an asset deal has been a common approach adopted for acquiring the businesses from Chinese domestic enterprises, the PRC authorities are also studying the subject of how foreign investors may acquire equity interest directly in domestic entities. Under an asset or share deal, tax planning is essential in maximising the tax opportunities arisen from such an acquisition as well as to manage the tax downsides and exposures associated with the merger and acquisition transactions.

HONG KONG

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SECTIONS

GENERAL INFORMATION

(i) Introduction

Hong Kong imposes profits tax on a person carrying on a trade or business in Hong Kong in respect of his assessable profits sourced in Hong Kong from that trade or business. Income that is derived from non-Hong Kong sources, and Hong Kong sourced capital gains, are not subject to profits tax. In addition, dividends and bank interest income which have a Hong Kong source are also generally not subject to profits tax.

The rules apply equally to Hong Kong incorporated entities (generally limited liability companies) and foreign entities carrying on business in Hong Kong through a branch.

Under certain circumstances, an individual will be exempt from salaries tax in Hong Kong to the extent that their earnings are sourced outside Hong Kong.

(ii) Common Forms of Business Entity

The principal forms in which a business can be conducted in and through Hong Kong are as follows:

a) Company incorporated in Hong Kong:
- Private;
- Public (normally listed on the Stock Exchange of Hong Kong).

b) Branch of a foreign company.

c) Representative or liaison office of foreign company.

d) Partnership.

e) Unincorporated joint venture.

Private companies and branches of foreign companies are the business entities most commonly used by foreign investors, since limited liability is usually desirable. The use of a Hong Kong company is generally the simpler option, but there may be tax advantages for some foreign investors in using a branch of a foreign company.

(iii) Foreign Ownership Restrictions

Hong Kong has a relatively unregulated business environment, with no restrictions on foreign ownership on local businesses (except in relation to television broadcasting), no exchange control or restrictions on profit repatriation.

(iv) Tax Rates

Profits tax at 16%, is charged on a corporation's assessable profits, which is effectively accounting profits, as adjusted for tax purposes. There are generally no withholding taxes other than a 1.6% (16% in some cases) on certain royalty payments and a tax equivalent to 0.5% on the gross proceeds of goods sold by an agent on behalf of a non-resident which is not itself registered for tax purposes in Hong Kong.

(v) Taxation of Dividends

Dividends are generally not subject to profits tax in Hong Kong.

(vi) Tax Losses

Tax losses may be carried forward indefinitely to offset against a company's future taxable profits. However, losses may be disallowed if there has been a change in the loss company's shareholding, following which profits start to accrue, and the sole or dominant purpose of the change in shareholding was to use up those losses. This provision is unlikely to be invoked for a commercially driven company acquisition/restructuring.

There is no tax consolidation in Hong Kong, so profits and losses arising in different companies of the same group have to be carefully managed so as to minimise profits tax on a group basis.

(vii) Thin Capitalisation

There are no formal debt-equity restrictions in Hong Kong. However, there are stringent conditions for the deductibility of interest which may effectively restrict the use or method of overseas debt finance.

(viii) Other Taxes

There are currently no GST/VAT or turnover taxes. Property tax applies to the net assessable value of real property located in Hong Kong, but if companies are subject to profits tax on income received from the property, property tax will not be applied.

Capital duty of 0.1% applies to increases in authorised share capital (capped at HK$30,000 per case) of a company.

Stamp duty at rates of up to 3.75% applies on conveyances of immovable property.

The rate for transfers of Hong Kong Stock, being shares and the transfer of which is required to be registered in Hong Kong, is 0.2% which is payable by the vendor and purchaser in equal shares (ie. 0.1% each).

There is an exemption from Stamp Duty, for a conveyance of an interest in immovable property or a transfer of Hong Kong stock, between companies with a 90% common shareholding.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

Subject to the clawback of any tax depreciation allowances previously claimed in respect of the relevant depreciable assets and the impact of any stamp duty costs, a Hong Kong seller of a Hong Kong target company will often be neutral over whether to sell the company's shares or assets: gain on both shares and capital assets should generally not be taxable while the distribution of retained profits after an asset sale is similarly non-taxable.

The issue of what constitutes a capital asset has been the subject of many court decisions in Hong Kong. Thus it would be prudent to ascertain the true nature of such asset before deciding on the type of deal to enter.

A non-Hong Kong seller will also have foreign tax considerations to take into account. Many investments into Hong Kong are made through holding companies based in low tax jurisdictions, in which case a share disposal may be preferred if the capital gains derived from the disposal of such holding company are treated more advantageously under the tax legislation of the ultimate owner's home tax jurisdiction.

(ii) Buyer's Perspective

A buyer generally has a variety of considerations to bear in mind, apart from the basic commercial and financial implications of the choice. Factors which may offset the usual concerns over the unknown liabilities which might be locked in a company include:

- losses which it would be preferable to preserve and utilise in the target company;
- real estate in the target company which, as noted above, would result in a significantly higher stamp duty cost if an asset purchase took place;
- potentially higher tax bases for depreciable assets; and
- simplified transaction formalities (e.g. contracts may remain undisturbed).

Interest is only deductible in Hong Kong if it is incurred for the purposes of producing assessable profits, and meets one of a number of specified conditions. Thus, interest paid on debt incurred for the purposes of acquiring shares (from which non-assessable dividends will be derived) is not tax deductible whereas interest on debt incurred under an asset deal should prima facie be tax deductible (see below).

Share dealers and venture capitalists who carry on business in Hong Kong should, however, be treated differently. They will normally not be able to claim profits from a share disposal as being capital and non-taxable, but on the other hand, they should be allowed a tax deduction on interest on debt used for acquiring such shares. Share dealers and venture capitalists who do not carry on business in Hong Kong would not be subject to tax on profits from the disposal of shares, and accordingly would not be able to obtain a tax deduction for any interest costs.

STRUCTURING AN ASSET DEAL

One issue that will interest the seller in an asset deal is the apportionment of consideration, particularly in relation to assets qualifying for tax depreciation. For fixed assets other than buildings, these assets may be depreciated over a shorter period for tax purposes than for accounting purposes, and therefore a disposal at net accounting book value can give rise to a clawback of tax depreciation, that is, a taxable 'balancing charge'. This will be advantageous where the seller has tax losses to use up, especially since the buyer will in turn inherit the higher tax bases for future depreciation purposes.

The following points may also be noted in relation to asset valuation:

- real estate should be transferred at market value, otherwise the value for stamp duty purposes may be challenged;
- the tax authorities have the power to deem transfer of assets between connected persons for tax purposes at market value.
- inventory may be assigned at any chosen value (irrespective of whether the parties are connected persons or not), provided the transfer results from a cessation of business and the buyer can claim a Hong Kong tax deduction for the inventory cost. Otherwise, market value should apply;
- an asset purchase that involves a substantial payment for goodwill, which is not tax deductible, may dilute future earnings.

In the case of an asset deal, a Hong Kong profits tax deduction may be obtained for financing costs, provided certain conditions are met. In principle, interest on finance obtained from a Hong Kong or overseas financial institution is deductible, but interest on finance from a non-financial institution is generally only deductible if the interest is subject to Hong Kong tax in the hands of the recipient (unlikely in the case of an overseas company). There are provisions which operate to deny a deduction for interest under a 'back to back' arrangement with financial institutions. There are further conditions which permit a deduction in certain circumstances for interest paid on loans to solely finance the acquisition of stock and fixed assets, and on debentures and marketable instruments.

Due to the interest deduction restrictions on intra-group financing for asset and share purchases, complex structures have been developed which may achieve the effect of an interest deduction for offshore finance, although at the risk of challenge from the tax authorities.

EXIT ROUTE

For the Hong Kong and foreign based investor alike, investments in Hong Kong (either in the target company or Newco to which the target's assets have been transferred) are often structured through a holding company in a tax haven or low tax jurisdiction, such as the British Virgin Islands. In the absence of withholding taxes or tax on capital gains, this involves no additional tax cost, and may provide flexibility for stamp duty planning. Some investors also believe that such a structure mitigates political risk.

As indicated above, profits derived from sale of investment such as associated company or a subsidiary, should not be taxable in Hong Kong. In addition, profits on sale of a target in Hong Kong through listing of the shares of the target or on a sale subsequent to the listing may be structured such that they are not taxable.

ENDING REMARKS - PREPARATION FOR A DEAL

A seller will be concerned to ensure that no Hong Kong or overseas tax arises in respect of the disposal, other than tax which can be sheltered using existing tax losses. In suitable situations, pre-sale restructure should be considered.

A buyer will be mainly concerned with structuring the investment (and minimising Hong Kong and overseas taxes on any exit), how to finance the investment, and the different transaction costs of the alternative routes. Careful planning from the outset should assist in maximising the buyer's rate of return on its acquisition.

INDIA

Country M&A Team

Country Leader ~ Somnath Ballav
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SECTIONS

GENERAL INFORMATION

(i) Introduction

India is the largest democracy in the world with a stable political system. Although agriculture plays a crucial role, the developing Indian economy is supported by a sophisticated industrial base with a wide spectrum of industries. There has been a phenomenal growth in the service sector in the past few years particularly in the areas of financial services, computer software development, IT-enabled services and telecommunications.

With substantial foreign exchange reserves showing a rising trend, the balance of payments position is comfortable. The current inflation rate is amongst the lowest in the world.

An established and fair judicial system, English as the language normally and widely used in business and commerce, supported by a substantial army of low-cost and highly technically skilled work force especially in the field of software development and IT-enabled services, are some of the prime movers which make India an attractive destination for foreign investors for sourcing their products. These factors, coupled with the bludgeoning middle class, have turned the Indian market place into a hot spot the foreign investors.

(ii) Common Forms of Business Entity

The principal forms of business organisation in India apart from government concerns are :

a) Company

A company may be incorporated under the Indian Companies Act either as a public or private company. To qualify as a private company, its Articles of Association must provide for the restriction of the right to transfer its shares, limit the number of shareholders to 50 and prohibit invitation to the public to subscribe to shares or debentures. All companies other than private companies are public companies.

b) Partnership

The Indian Partnership Act is the governing law which prohibits partnerships of more than 10 persons from carrying on the business of banking and more than 20 persons for other business. Limited liability partnerships are not legally recognised.

c) Sole proprietor

There are no special provisions corresponding to Companies Act or Partnership Act governing sole proprietorships. However, the Indian Income Tax Act makes it obligatory to have compulsory audit if the turnover/gross receipts from business or profession exceeds certain prescribed limits.

d) Association of persons

A joint venture as distinct from partnership is formed for a specific purpose. It is not a legal entity separate from those of the joint venturers. For tax purposes, a joint venture formed with the intention of carrying out a common purpose and produce income jointly is treated as an association of persons and constitutes a taxable entity.

In the Annual Budget for 2002, it is proposed that a joint venture would be treated as an Association of Persons for tax purposes irrespective of whether or not it was established to produce income jointly.

(iii) Foreign Ownership Restrictions

a) Foreign Direct Investment (FDI)

Under the liberalised exchange control regime, laws scripted in the Foreign Exchange Management Act (FEMA), 1999 and the Industrial Policy of the Government, FDI has been permitted under the Automatic Route subject to conditions, except for sectors included in the restricted list which are:

- housing for investment other than investment by non-resident Indians;
- atomic energy & related projects;
- agriculture;
- print media; and
- broadcasting.

Subject to certain conditions, 100% Foreign Equity is now permitted in a majority of sectors which include:

- manufacturing activities in Special Economic Zones (SEZ) except in restricted areas like arms and ammunition, explosives and allied items of defence equipment, including aircrafts and warships, atomic substances, narcotics, tobacco and alcohol brewery.
- Investment by offshore venture capital funds/companies in domestic VC undertakings as well as other companies, subject to SEBI regulations and sectoral caps.

Prior government approval (FIPB Clearance) for FDI is required if the conditions prescribed under the Automatic Route are not met, which includes FDI in excess of the applicable sectoral caps.

Transfer by a non-resident of shares held in an Indian company to another non-resident does not require FIPB approval.

Acquisition of shares in companies listed in the stock exchanges in India in excess of the limits prescribed in the Takeover Code of the Securities Exchange Board of India (SEBI) is subject to the regulations and the procedures prescribed in the Takeover Code.

b) Extractions from Technology Transfer

- Payments of royalty up to 2% on exports and 1% on domestic sales are allowable under the Automatic Route on use of trademark and brand name of foreign collaborator without technology transfer.
- Payments of royalty upto 8% on exports and 5% on domestic sales (including payments made by wholly-owned subsidiaries to off-shore parent) are allowable under the Automatic Route without any restrictions on the duration of the royalty payments.

c) Convertibility

- Current Account transactions except in limited areas have been made convertible under the FEMA and the related regulations. Unless specifically allowed under FEMA and the related regulations, Capital Account transactions require prior approval of the Reserve Bank of India (RBI).

(iv) Tax Rates

a) Corporate Tax

Indian companies	35% plus a surcharge of 2% (effective tax rate 35.7%) is applicable to all domestic companies. The surcharge to be increased to 5% as per proposals in the Annual Budget for 2002 (effective tax rate 36.75%).
Foreign companies	48%. As per the proposals in the Annual Budget for 2002, the basic rate of 48% to be reduced to 40% but a surcharge of 5% (on 40%) is to be levied making the effective tax rate 42%.
Association of persons formed by two companies in which their shares are fixed and determinate	Share of profits attributable to the respective companies to be taxed at the rate applicable to the company. For example, in the case of a joint venture between a foreign company and a domestic company, the share of profits fixed and attributable to the foreign company currently attracts tax at 48% whereas the balance suffers tax at 35.7% (35% plus surcharge at 2%)

b) Withholding Tax

Tax is withheld at 20% from taxable interest paid to foreign companies on borrowings or debts incurred in foreign currency. As per proposals in the Annual Budget for 2002 such interest will also suffer a surcharge of 5% of the withholding tax. Moreover, as per the said proposals dividends payable to shareholders including foreign companies and other non-residents will suffer withholding tax of 20% plus a surcharge of 5% of 20%.

The rate of withholding tax on royalties and fees for technical services payable to foreign companies under agreements which are either approved by the Government or are in accordance with the declared industrial policy is 30% and 20% if the approved agreement is made after 31 May 1997.

India has a comprehensive network of Double Taxation Avoidance Agreement (Tax Treaty) pursuant to which the withholding tax on the above income may be reduced depending on the treaty with the country of which the recipient of income is resident.

Any tax borne by government or Indian concern on behalf of a foreign company on income by way royalty and fees for technical services is currently exempt from tax in the hands of the foreign company. However, such taxes borne pursuant to agreements entered into on or after 1 June 2002 is proposed to be treated as income in the hands of the foreign company as per proposals in the Annual Budget for 2002.

(v) Taxation of Dividends

Under the existing tax regime, a domestic company declaring, distributing or paying dividend is required to pay a dividend distribution tax of 10% plus a surcharge of 2% (effectively 10.2%). The dividend is not subject to tax in the hands of the shareholder.

However, the Annual Budget for 2002 has proposed that the existing rule will cease to apply to dividends declared, distributed or paid on or after 1 April 2002 which would henceforth be taxed in the hands of the shareholders. To avoid a cascading effect, the Annual Budget for 2002 has proposed that dividend received by a domestic company from another domestic company will not be subject to tax to the extent to which it is redistributed to the shareholders of the recipient company within the due date of filing the corporate tax return of the recipient company.

As per the proposal in the Annual Budget for 2002, foreign companies receiving dividend income would be subject to tax at 20% plus surcharge of 5% (effective rate of 21%). A lower rate may apply depending on the treaty with the country of which the recipient is a resident.

(vi) Tax Losses

Change in ownership of a company through share acquisition does not affect the carry-forward and set-off of unabsorbed business loss and unabsorbed depreciation within the permitted period.

However, where the acquired company is a company in which public are not substantially interested (i.e. a closely held company whose shares are not listed in any recognised Indian stock exchange) the benefit of unabsorbed business loss is lost if on the last day of the fiscal year in which the acquisition takes place, shares carrying more than 50% of the voting rights are not beneficially held by the same shareholders who beneficially held shares of the acquired company carrying not less than 51% of the voting power as on the last day of the fiscal year in which the loss was incurred.

The above restriction is not applicable where the acquired company is a subsidiary of a foreign company and at least 51% of the shareholders of the parent foreign company pursuant to a scheme of amalgamation or demerger continue to remain shareholders of the amalgamated or demerged foreign company.

The unabsorbed business loss and unabsorbed depreciation of an amalgamating company owning an industrial undertaking or a ship can be carried over by the amalgamated company provided prescribed conditions are satisfied.

In a reverse merger situation, carry-forward of unabsorbed business loss and depreciation is automatic.

Industrial undertaking means an undertaking engaged in the manufacture or processing of goods or computer software or business of generation or distribution of electricity or any other form of power, mining, construction of ships, aircrafts and railway systems. As per proposals in the Annual Budget for 2002, undertakings providing telecom services will be treated as industrial undertakings.

(vii) Thin Capitalisation

No formal thin capitalisation rules are in force in the country. There are no prescribed debt-equity ratios, which are generally driven by commercial considerations.

(viii) Other Taxes

Other taxes relevant for the purpose of merger and acquisition are:

a) Sales Tax

Sales tax is levied on both interstate and intrastate sales. Each state has its own sales tax laws (covering works contract tax, turnover tax and purchase tax),under which intrastate sale suffer tax at varying rates.

The Central Sales Tax Act covers interstate sales. Registered dealers enjoy concessional rates.

India is in the process of implementing a national level Value Added Tax (VAT) in place of sales tax, which is expected to be in force from 1 April 2003.

b) Stamp Duty

Stamp duty is not leviable on transfer of shares held in the dematerialised mode. However, transfer of shares held in physical form attracts stamp duty generally at 0.5% statutorily payable by the buyer. Stamp duty is levied on transfer of immovable property at rates varying from state to state.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profit on Sale of Shares

Gains derived by foreign companies on transfer of shares in Indian companies are subject to tax in India at the rate of 48% (40% plus a surcharge of 5% on 40% proposed in the Annual Budget for 2002) in the case of short-term capital gains and at 20 % (plus a surcharge of 5% proposed in the Annual Budget for 2002) in the case of long-term capital gains. However in the case of shares listed in a recognised stock exchange in India, the tax is capped at 10% of the gains (plus a surcharge of 5% on the 10% as proposed in the Annual Budget for 2002). Indexation benefit is not available.

For the purpose of computing the capital gains tax liability, the cost of acquisition, expenses incurred in connection with the transfer and the consideration receivable for the transfer are required to be converted in the same foreign currency as that utilised for the purchase of such capital asset and the resultant capital gain reconverted into INR.

However, no capital gains tax is imposed on transfers of shares in Indian companies by one foreign company to another in a scheme of amalgamation, if at least 25 percent of the shareholders of the amalgamating company continue to remain the shareholders of the amalgamated company and the transfer is exempt from capital gains tax in the country where the amalgamating company is located.

It is proposed in the Annual Budget for 2002 that long-term capital loss, which is eligible under the existing tax regime to be set off within the permitted period against any capital gain whether long-term or short-term, shall with effect from 1 April 2002 be set off only against long-term capital gains.

b) Distribution of Profits

Distribution of profits will depend on the form of the business entity of the seller. In a corporate entity, Indian company law regulations require a maximum retention up to 10% of the profits prior to distribution of dividends except in the case of liquidation. Under the existing laws, the company distributing dividend of the balance of the profits after the retention of the amount required under the

Indian Company Law Regulations has to pay dividend distribution tax at an effective rate of 10.2%. The balance may be distributed to the shareholders by way of dividend without any withholding tax because dividends under the existing laws are not taxed in the hands of the shareholders. However, the position will change once the proposals regarding the taxability of the dividend in the hands of the shareholders, mooted in the Annual Budget for 2002 are enacted as indicated under the paragraph 'Taxation of Dividends'.

(i) Buyer's Perspective

a) Acquisition Structure

In a share deal, the cost of the assets cannot be revalued. Further, in the case of the acquisition of a listed company, the acquirer has to comply with the Takeover Code regulations which, *interalia,* makes it mandatory for the acquirer to make an open offer to the public shareholders of the acquired company for purchasing their holding. Acquisition through an overseas intermediate company (having substance) located in Mauritius can be considered because of preferential tax treatment with regard to dividend and capital gains tax under the India–Mauritius tax treaty.

This remains the most preferred method of acquisition and it is also cost effective as compared to an asset deal because of stamp duty implications.

b) Funding Costs

Under the existing tax regime, it is preferable to treat the financing cost incurred in acquiring the shares as a part of cost of acquisition because such cost are not tax deductible against the dividend income which is exempt from tax in the hands of the shareholders. However, after the dividends become taxable in the hands of the shareholders on enactment of the proposals in the Annual Budget for 2002, the financing cost incurred in acquiring the shares after the acquisition will be eligible for tax deduction against the dividend income.

c) Acquisition Expenses

The acquisition expenses directly related to the share purchase are allowed to be added to the cost of the shares and are eligible for tax deduction in determining capital gains on sale.

d) Debt/Equity Requirements

There are no prescribed debt-equity ratios, which are generally driven by commercial considerations

e) Preservation of Tax Losses

The benefit of tax concessions, incentives, carry-forward of prior years' tax losses and unabsorbed depreciation is not lost in a share deal involving the acquisition of a company except in case of a company in which the public are not substantially interested to the extent indicated under the paragraph 'Tax Losses'.

f) Repatriation of Profits

Repatriation of profits in a share deal can only be through the dividend route. The tax implications both for the company distributing the dividend and the shareholders have been dealt with under the paragraphs, 'Taxation of Dividends' and 'Distribution of Profits'.

Stock dividends (on equity shares) in the form of bonus shares are not taxable in the hands of the recipient. However the entire consideration received on any subsequent sale of such shares would be subject to capital gains as the cost of acquisition of such shares is considered to be nil.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

a) Profit on Sale of Assets

In case of depreciable assets, the income tax written down value of the block of assets (ITWDV) is reduced by the consideration received from the sale and consequently depreciation at the rate applicable to the block of assets is allowed on the reduced ITWDV. If the consideration receivable for the transfer of the assets exceeds the ITWDV, the excess is considered to be a short-term capital gain and subjected to tax at the corporate tax rate applicable to the entity. In the case of non-depreciable assets, the short-term capital gain is taxed at the corporate tax rate applicable to the entity whereas the long-term capital gains computed (after allowing indexation benefits and substitution of the cost price as on 1 April 1981 if purchased prior to that date) attracts capital gains tax at 20% plus applicable surcharge of 2% on 20% (the surcharge increases to 5% as per proposals in the Annual Budget for 2002).

The Annual Budget for 2002 has proposed that for the purpose of computing the capital gains tax liability, the valuation adopted by the registration authorities for levy of stamp duty in connection with the transfer of immovable property shall be adopted if it is more than the consideration receivable for the transfer of the said immovable property.

Gains on transfer of assets situated in India are subject to tax in India at the rate of 40% plus a surcharge of 5%) in the case of short-term capital gains and at 20 % (plus a surcharge of 5%) in the case of long-term capital gains.

The seller would be liable to sales tax on movable property at appropriate rates depending on whether it is an inter-state or intra-state sale.

b) Distribution of Profits

Distribution of profits will depend on the form of the business entity of the seller. In a corporate structure, it can be distributed by way of dividends. The tax implications both for the company distributing the dividend and the shareholders have been dealt with under the paragraphs, 'Taxation of Dividends' and 'Distribution of Profits'.

(i) Buyer's Perspective

a) Acquisition Structure

In an asset deal, the acquirer may opt to buy the assets of the company for a slump price and based on a valuation report allocate the purchase price properly to the respective assets to ensure the maximum benefit on account of depreciation and amortisation allowed under the tax laws.

It should be kept in mind that the buyer would be liable for stamp duty on transfer of immovable property at a rate which varies from state to state.

The purchase of assets of an Indian company by a foreign company requires the permission of the regulatory authorities unless the purchase is routed through an Indian subsidiary of the foreign company.

b) Funding Costs

If the assets are acquired through an existing Indian subsidiary engaged in business, the interest on loan taken for the acquisition of the assets is considered as a tax-deductible expenditure to the Indian company.

c) Acquisition Expenses

The acquisition expenses directly related to the purchase of the assets will be added to the cost of the assets and be eligible for depreciation allowance in the case of depreciable assets. For non-depreciable assets, such costs will be eligible for tax deduction when the assets are sold.

d) Cost Base Step-Up

In an asset deal, the acquirer may opt for buying the assets of the company for a slump price and based on a valuation report allocate the purchase price properly to the respective assets to reap maximum benefit on account of depreciation allowance and amortisation allowed under the tax laws. This may be resisted by the seller for adverse sales tax implications.

e) Treatment of Goodwill/IP

The goodwill arising out of an asset deal cannot be amortised by the buyer. However, the benefit of the cost of acquisition is available on subsequent disposal. Currently, the cost of intangible assets (such as know-how, patents, copyrights, trademarks, franchises or any other business or commercial rights of a similar nature) can be depreciated at the prescribed rates. Due regard should therefore be given for identifying and allocating proper values to such intangible assets.

f) Other Matters

An asset deal normally attracts heavy incidence of stamp duty at rates varying from state to state on transfer of immovable property which the acquirer has to bear.

EXIT ROUTE

The exit route in the case of a share deal is the transfer of the shares of the Indian company. The tax implications are indicated under the paragraph, 'Profit on Sale of Shares'. Transfer of shares of offshore holding company can also be considered.

The exit route in the case of an asset deal is the transfer of the assets. The tax implications are indicated under the paragraph, 'Profit and Sale of Assets'.

ENDING REMARKS - PREPARATION FOR A DEAL

The relative considerations of the buyer and seller will depend on the facts of each case. The buyer should weigh the possibility of increasing the asset base through asset acquisition against high stamp duty, loss of unabsorbed losses and depreciation, and recapture of past capital allowances. The buyer should ensure that the acquisition is structured in a manner which would result in improving shareholder value and optimising return on investments.

INDONESIA

Country M&A Team

Country Leader ~ Melisa Himawan
Ay-Tjhing Phan
Ray Headifen
Rizal Bawazier

SECTIONS

GENERAL INFORMATION

(i) Introduction

With a population of over 200 million people and significant natural resources, Indonesia represents both a significant market and potential supplier to the world economy.

The Indonesian government officially welcomes both domestic and foreign private investment. Over the past several years, the Government has progressively sought to liberalise the local rules governing foreign investment. Indonesia is in the midst of a serious effort to promote foreign investment, capital accumulation and the export of goods other than oil and gas to expedite economic development and to become internationally competitive. A broad range of deregulatory measures have been implemented, and additional measures can be expected to further enhance the investment climate.

The Indonesian government has passed a number of broad ranging amendments to the tax laws arising from a recent tax reform review. These new laws have been in effect since 1 January 2001.

(ii) Common Forms of Business Entity

The most common form of business entity used by foreign investors in Indonesia is the limited liability company (or PT Company).

Other forms of business entity include:

- Partnership or Joint Operation (such as the KSO which are used in the telecommunications industry)
- Branch of a foreign company (in very limited circumstances such as construction activities approved by the Ministry of Public Works or Production Sharing Contracts in the Oil and Gas industry)
- Trade Representative office (a liaison office with very limited activities).

(iii) Foreign Ownership Restrictions

A foreign investor may acquire shares in an existing foreign owned company (PMA) or convert a locally owned company (PMDN) to a PMA. Acquisition of such a company is permitted as long as the proposed business activities of the company are open for foreign investment.

There are various restrictions on foreign investment which are dependent on the type and nature of activity undertaken. Four broad categories of business restriction exist:

- business closed to all investors including local investors, for example, harmful chemical production;
- business closed to foreign investors e.g. natural forest concessions and radio and television broadcasting services;
- business where a foreign investor may be a joint venture party, for example, shipping, electricity production, transmission and distribution; and
- business investment open to all investors but subject to certain restrictions, for example, aqua culture and pulp wood industries.

The types of activity listed in each of the above categories are extensive. These are contained in what is referred to as a negative investment list.

Foreign investors should therefore enquire as to the foreign investment rules governing the appropriate sectors of their investments before embarking on any merger or acquisition deal in Indonesia.

A foreign investor may now own 100% of the shares in an Indonesian company. However, it is still required to be owned by two or more shareholders. Although there is no specific indication of the required percentage, a transfer of at least a nominal proportion of equity (divestment) by the foreign investor to an Indonesian party or parties is required within 15 years. At the time of the establishment of a joint venture company operating in a sector previously closed to foreign investment, an Indonesian shareholding of at least 5% is required.

A foreign investment company may set up new companies and purchase shares of a PMDN and non-facility companies as long as the business activities of the company are open for foreign investment. However, while holding companies are common amongst local conglomerates, foreign owned holding companies are not commonly used.

(iv) Tax Rates

a) Corporate Tax

The profits of an Indonesian resident corporation, including a foreign company that carries on business in Indonesia, is subject to corporate income tax. The corporate tax rates are as follows:

Income (RP)	*Tax Rate (%)*
Up to 50 million	10
From 50 to 100 million	15
Greater than 100 million	30

In addition, remittance of profits of a branch of a foreign entity is subject to 20% withholding tax (unless reduced by a double taxation agreement).

b) Withholding Tax

Withholding tax is levied on a variety of payments made to corporations and individuals, resident and non-resident, at the following rates.

	Dividends	*Interest*	*Royalties*	*Branch Profit Tax*
Resident corporations	Nil /15%	15%	15%	N/A
Resident individuals	15%	15%	15%	N/A
Non-resident (non-treaty countries)	20%	20%	20%	20%

The withholding tax on income derived by a non-resident may be reduced under a double taxation agreement.

Branch profits of a permanent establishment that will be reinvested in companies established in Indonesia within the same year, or the following year at the latest, are not subject to the 20% withholding tax. The investment should be in the form of capital participation and should be invested for at least two years after the investee company starts commercial production.

Different withholding tax rates apply to service fees depending on the types of service provided by the service provider. The rates are as follows:

Resident corporations and individuals	1.5% to 7.5%
Non-resident (non-treaty countries)	20%

Certain gross income received by resident corporations and individuals is subject to a 'final' tax as follows:

Rental of land and buildings	6% or 10%
Sale of stock exchange share (founder shares 0.6%)	0.1%
Sale of non-listed shares by non-residents (subject to tax treaty protection)	5%
Interest from an Indonesian Bank	20%
Insurance premiums paid to non-resident insurance companies:	
- by the insured	10%
- by Indonesian insurance companies	2%
- by Indonesian reinsurance companies	1%
(the withholding tax rates my be reduced or exempted by tax treaty agreement)	

Final tax is generally withheld by the payer and represents the only tax liability on the income.

(v) Taxation of Dividends

Dividends income, in whatever name or form, is taxable when accrued or paid whichever is the earlier. Dividends received from Indonesian companies by limited liability companies incorporated in Indonesia (PT Company), cooperatives, and states or region-owned companies (BUMN/BUMD) are exempt from 15% withholding tax if all of the following conditions are met:

- the dividends are paid out of retained earnings;
- the shareholder holds at least 25% of the paid-in-capital; and
- the shareholder has an 'active business' other than shareholding.

Dividends are non-deductible for corporate income tax purposes.

Dividends paid by or due from an Indonesian company to a non-resident are subject to a final withholding tax at a rate of 20% of the gross amount. This rate may be reduced by double taxation treaties typically to 10% or 15%. The double tax treaty with Mauritius currently has a 5% withholding tax rate on dividends paid to 'substantial' shareholders (i.e. a Mauritius resident which owns at least 20% of the capital of the Indonesian company).

Dividends from overseas subsidiaries generally are taxed in the year they are declared, whether or not they are remitted to Indonesia. Credit is available for overseas tax withheld or paid, but it does not extend to underlying corporate taxes unless provided for in a relevant double tax agreement.

(vi) Tax Losses

Losses may be carried forward for a maximum of five years. However, for a limited category of business in certain regions, the period can be extended up to 10 years. Losses are not permitted to be carried backwards. Indonesia does not have continuity of ownership or continuity of same business tests that operate to restrict tax loss utilisation. There are no consolidation or group losses transfer provisions.

(vii) Debt/Equity

a) *Type of Equity*

Companies may be capitalised by the issue of equity shares privately or publicly on a stock exchange. Shares must be issued at par and can be subscribed for by cash or in certain circumstances by injection of assets. A minimum of 25% of a company's authorised share capital must be issued, of which 50% must be paid up. The current law on limited liability companies permits companies to issue different classes of shares with special, conditional or limited voting rights and profit appropriation participation although this is rarely done.

b) *Ratio*

Currently, there are no prescribed debt/equity ratio for tax purposes, except in the mining industry by virtue of the terms of contracts of work. A minimum debt to equity ratio is generally imposed through the foreign investment regulatory approval process. The Minister of Finance is authorised by the tax law to determine an acceptable debt-to-equity ratio for tax purposes, although he has not prescribed a debt-to-equity ratio to date.

c) *Deductibility of Funding Costs*

Interest is generally a deductible expense for the borrowing company provided it has been incurred for the purposes of generating taxable income. Interest on borrowing used to finance equity investment in newly established companies or to participate in rights issues is tax deductible.

(viii) Tax Issues Relating to Merger

There are special rules which provide concessions for certain qualifying mergers and consolidations. These concessions include:

- no gain or loss on the transfer of assets;
- the transferor company would not be subject to 5% tax on the transfer of land and/or buildings; and
- subject to certain conditions (including a revaluation of the transferor's fixed assets) a transferor's tax losses may be carried over to the surviving company.

(ix) Other Taxes

a) Value Added Tax (VAT)

VAT is imposed on importers, providers of most goods and services, and users of intangible goods and services originating from outside Indonesia or within Indonesia. The rate of VAT is currently 10%, however special rates (less than 10%) apply to certain goods or services. The export of goods from Indonesia are zero rated.

b) Luxury Sales Tax (LST)

LST is imposed once only, upon the delivery or sale of specified luxury goods by a manufacturer or upon import. The rates of tax range from 10% to 75% depending on the type of goods.

c) Stamp Duty

Only nominal stamp duty is payable, at either Rp 6,000 (US$ 0.60) or Rp 3,000 (US$ 0.30) on certain documents, such as letters of agreement, proxies, statement letters, notarial deeds etc.

d) Land and Building Tax

Land and building tax is payable annually on land and building, and on a permanent structure. The effective rate is generally not more than 0.1% per annum of the value of the property.

e) Land and Building Transfer Tax

The seller and the buyer are each required to pay a tax of 5% which is computed on the transfer value or the value forming the basis of the land and building tax (NJOP) whichever is higher.

The tax payable by the seller represents a prepayment of its corporate tax liability and is available as a credit in its annual corporate tax computation. The tax payable by the purchaser may not be claimed as a credit and therefore represents an additional cost of such an acquisition.

The duty payable by the purchaser on the acquisitions of title to land and buildings is extended to acquisition via inheritance or as part of a business merger, consolidation, or expansion. The duty may be reduced by 50% where the land and/or building are transferred in connection with a merger. The contractual date of a business merger, consolidation or expansion is considered as the due date for the payment of such duty.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profit on Sale of Shares

There are a number of considerations surrounding a share acquisition by an offshore entity. The sale of shares in an unlisted Indonesian company by a non-resident attracts a withholding tax of 5% of gross proceeds due to the vendor. However, the vendor may be protected from this tax under a tax treaty. It should be noted that where the seller is a resident of Australia or Singapore, Indonesia's tax treaties with Australia and Singapore do not provide for such an exemption.

Any capital gain on the sale of unlisted shares by resident corporations is treated as ordinary income and subject to corporate tax at normal corporate rates.

Shares listed on an Indonesian stock exchange are subject to a tax of 0.1% of gross proceeds (0.6% for founder shares).

The sale of shares is likely to be the preferred approach for the seller, as this tax liability is a once-off income tax on the profit on disposal. In many cases, offshore elements are often introduced into share transactions so as to further limit the Indonesian tax on disposal.

b) Stamp Duty

Only nominal stamp duty is payable on the issue of shares at Rp 6,000 per document.

(ii) Buyer's Perspective

a) Acquisition Structure

Foreign investment regulatory rules mean that most share acquisitions are structured as direct investments from outside Indonesia. Acquiror generally seek to hold Indonesia target companies through a company located in a country which has entered into a double tax treaty agreement with Indonesia. The choice of a suitable jurisdiction will depend on the acquiror's own tax considerations.

b) Funding Cost

Interest paid on borrowing to finance a share acquisition must satisfy normal tests for deductibility. Where a local corporate taxpayer uses borrowing to finance a share acquisition, interest would be generally not deductible because any dividends received would not be taxable. Dividends are not taxable where:

- the dividends are paid out of retained earnings;
- the relevant shareholders hold at least 25% of the paid in capital; and
- the relevant shareholders have an 'active business' other than shareholding (i.e. a holding company).

Interest on borrowing used to finance equity investment in newly established companies or to participate in rights issues is deductible.

c) Equity Structure

The minimum capital requirement is Rp 20 million. The minimum allowable foreign investment may be determined by the investors on the basis of the scale of the business. It may comprise both debt and equity.

d) Preservation of Tax Losses, Tax Depreciation and Tax Incentives

A change in ownership of the shares of a company does not alter the depreciation allowances claimed by the company or its carry-forward tax losses. There is no facility for stepping up or increasing the basis of assets to reflect the purchase price.

The acquisition of shares in a tax loss company in theory provides flexibility in loss utilisation because of the lack of provisions with regard to continuity of ownership or business.

e) Unpaid Taxes of the Acquired Company

Unpaid taxes or unrecorded liabilities of the company being acquired remain with the company. It is generally recommended to obtain warranties from the seller to meet unknown and undisclosed tax liabilities.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

a) Profit on Sale of Assets and Goodwill

Capital gains derived by a company on the transfer of goodwill and assets are taxed as income, and, after utilising any carry-forward tax losses, are subject to income tax at the maximum corporate rate of 30%.

The transfer of land and/or building will attract a transfer tax of 5% of the proceeds. This tax is creditable against the transferor company's annual income tax liability.

b) Value Added Tax

The transfer of assets is subject to 10% VAT. Specific concessions may be available, for example where the transferor company is a company not required to be registered for VAT purposes.

c) Stamp Duty

Stamp duty is not payable on the transfer of assets.

(ii) Buyer's Perspective

a) Selection of Acquisition Vehicle

An asset acquisition or transfer is subject to the approvals of various government departments including that of the foreign investment regulatory body (BPM).

The acquisition of assets may be effected either by an existing subsidiary company or through a newly established Indonesian entity.

Generally an asset acquisition is preferred in Indonesia because of the difficulties in determining the undisclosed liabilities (such as tax) of operating Indonesian entities. From 1995, the ITO has 10 years in which to initiate a tax audit and therefore potential tax exposures can arise long after an acquisition has been completed. In addition, the legal uncertainties in trying to enforce warranties and indemnities against vendors generally mean that assets acquisitions are preferred.

b) Unpaid taxes of the Transferor Company

Unpaid taxes or unrecorded liabilities remain with the seller.

c) Funding Cost

The buyer in an asset acquisition would be entitled to deductions for interest expenses on loans used to acquire such assets, provided the assets are used in generating income and the transaction has been effected at arm's length. Interest paid to non-residents will be subject to 20% withholding tax (reduced under most tax treaties).

d) Cost Base Step Up

On an acquisition of assets, the fixed assets should be recorded at transfer value for tax purposes. An asset appraisal may be required for related party transaction to determine the market value at the time of acquisition.

Purchased goodwill and cost of intangible property can be amortised under Indonesian accounting principles using the declining-balance method or the straight line method. The method adopted must be applied consistently. The amortisation will generally be deductible for tax purposes.

Assets other than buildings are divided into four classes. Depreciation is calculated on an asset-by-asset basis. Building are divided into two classes, permanent (useful life of 20 years) and non-permanent (useful life of 10 years). The current rates of depreciation are set out below.

Asset Category	*Declining-balance (%)*	*Straight-line (%)*
Class I	50	25
Class II	25	12.5
Class III	12.5	6.25
Class IV	10	5
Permanent building	-	5
Non-permanent building	-	10

Cost incurred to extend certain rights over land such as right to build, right to commercial use, and right to use, can be amortised over the useful life of the rights. Land acquisition costs remain non-amortisable.

e) Value Added Tax

VAT paid by the buyer should be available as input VAT which may be recovered against output VAT, or by claiming a refund. A request for a refund will automatically trigger a tax audit. Special concessions may be available, for example where the transferor company is a company not required to be registered for VAT purposes.

f) Land and Building Transfer Tax

On acquiring land and/or building, the purchaser must pay 5% transfer tax which is computed on the transfer value or the value forming the basis of the land and building tax (NJOP) whichever is higher. The tax paid is considered as cost of the acquiring company, that is, it is not creditable against income tax.

g) Withholding tax

No Indonesian withholding tax should apply on the transfer of assets.

EXIT ROUTE

The sale of the shares in an Indonesian company can provide a tax-free exit mechanism for foreign investors provided the seller is resident in a treaty country and the ‘capital gains’ article in the treaty gives protection from the 5% withholding tax discussed above.

Other profit extraction techniques such as interest, technical service fees and dividends can be used to provide an exit route for Indonesian profits but care will need to be taken to limit withholding taxes and ensure that Indonesia’s transfer pricing rules are not infringed.

ENDING REMARKS - PREPARATION FOR A DEAL

Indonesia represents significant opportunities for foreign investors. However, while warmly welcoming foreign investment, doing business in Indonesian often poses a unique set of challenges.

Careful planning is recommended at the earliest stage of consideration of a merger or acquisition in Indonesia. The legal, tax, government regulatory and human resources teams will need to work together to ensure that unnecessary hurdles are not overlooked at the outset.

JAPAN

Country M&A Team

Country Leader ~ Kan Hayashi
Shinji Ishiguro
Alfred Zencak

SECTIONS

GENERAL INFORMATION

(i) Introduction

Companies incorporated in Japan are subject to Japanese tax on their worldwide income. A branch of a foreign company is only subject to tax in Japan on its income that is attributable to the Japan branch.

Japanese corporations are entitled to claim a tax credit against their corporate and inhabitants taxes for foreign tax paid. Such foreign tax includes withholding tax and the underlying tax in respect of dividends from a foreign subsidiary (down to a second tier subsidiary).

Undistributed profit of a foreign subsidiary located in a tax haven (i.e. a territory which imposes a corporate tax of less than or equal to 25%) will be included in the taxable income of the Japanese parent unless it satisfies specific conditions for exemption from the rules. A foreign tax credit is available for any foreign taxes paid by a tax haven foreign subsidiary.

Capital gains and losses are treated as ordinary income and losses. However, a rollover provision for deferring the realisation of gains is available for gains realised from the sale of real property where the proceeds are reinvested in certain specific fixed assets.

Significant changes in the Japanese Commercial Code and corporate tax laws have taken place with respect to stock-for-stock exchanges and tax-free reorganisations and mergers in order to facilitate mergers and acquisitions and corporate restructurings.

(ii) Common Forms of Business Entity

The following table shows the most common forms of business entities in Japan prescribed under the Japanese Commercial Code:

Name of entity or legal form	*Description*	*Japanese tax features*
Japanese branch	Standard form for foreign companies operating in Japan	Japanese corporate tax payable on profit; no withholding tax on the remittance of branch profits
Kabushiki Kaisha (KK)	Standard company form	Japanese corporate tax payable on profit; withholding tax on dividends
Yugen Kaisha (YK)	'Small company' business company form	Basically same as KK, although it may be possible for US investors to treat a YK as transparent for US tax purposes
Tokumei Kumiai (TK; Undisclosed Association) under Commercial Code	Under a TK contract, parties agree that one (undisclosed party) of them shall make a contribution towards the business of the other (Operator) and that they shall allocate any profits or losses arising from such business.	Under a 2002 Japanese Tax Reform Draft, distributions made by a Japanese operator to investors in TK may be deductible for Japanese tax purposes. Distribution to non-Japanese resident investors (undisclosed party) will be subject to withholding tax regardless of the number of silent partners. The new treatment will become effective for TK profits to be distributed on or after 1 April 2002.

(iii) Foreign Ownership Restrictions

Generally, a foreign company is permitted to own 100% of a Japanese company, subject to certain reporting procedures.

Since the Japanese government has relaxed its foreign ownership policy, it is now easier for foreign investors to acquire Japanese companies directly.

(iv) Tax Rates

a) Corporate Tax

Japanese corporations and branches are subject to national corporate tax, local inhabitants tax and business enterprise tax. The current combined effective rate of tax (national and local) is approximately 42.05% after taking into account the tax deductibility of the business enterprise tax.

b) Withholding Tax

Japanese sourced dividends, interest, royalties, service fees, and rent received by a foreign corporation are generally subject to withholding tax (WHT) at the rate of 20% under Japanese domestic law. Since Japan has an extensive tax treaty network, lower tax rates may be available depending on the particular treaty that applies. Service fee that is not sourced in Japan and remittances of branch profits are not subject to WHT.

(v) Taxation of Dividends

Dividends, net of attributable financing costs, that are received by a Japanese company (ParentKK) from another Japanese company (SubKK) may be excluded from the taxable income of ParentKK provided that ParentKK owns 25% or more of SubKK. If ParentKK owns less than 25% of SubKK, only 50% (with a transitional rule that is applicable to small and medium sized companies) of the dividends from SubKK, net of attributable financing costs, may be excluded from the taxable income of ParentKK. There are also special rules relating to dividends received by minority shareholders and investment trusts and certain types of interest that may be excluded from the above definition of financing costs.

However, exclusion from taxable income is not permitted for dividends on shares that were acquired within one month prior to the year-end of the company paying the dividend and sold within two months after the same year-end.

The Japanese income tax (at 20%) withheld by the Japanese dividend paying company is generally recoverable by the recipient either as a credit against its tax liability or a refund if the recipient is in a tax loss position. There may be situations where the credit is not available and the recipient may only be allowed a deduction for the tax withheld against its income.

(vi) Tax Losses

Tax losses may be carried forward in Japan for a period of up to five years. Currently, losses may not be carried back except, for example, for tax losses incurred by small and medium sized corporations (i.e. a corporation whose capital is ¥100m or less and 50% or more of its stock is not held by a 'large company', including foreign company) in their first five years of operation. Such losses may be carried back one year upon application by the taxpayer.

A company may be permitted to carry forward losses that are incurred during the first five years after the date of incorporation for 7 years if it meets certain requirements.

A change in ownership of shares in a company or a change in the nature of a company's business does not give rise to the expiration or limitations on the use of tax losses in Japan. 'Latent' tax losses (e.g. the difference between the Japanese tax book value of assets and their actual market value) are generally not realised until a taxable event (e.g. a sale of the assets or a transfer of assets pursuant to a merger).

(vii) Thin Capitalisation

Interest arising from debts due to foreign controlling shareholders which are either Japanese non-residents or foreign corporations holding 50% or more of shares of a domestic corporation is not tax-deductible if the debt is in excess of three times the net equity of the Japanese company. The excess interest is permanently disallowed as a deduction (i.e., the disallowed interest deduction may not be carried back or forward). However, the excess interest may still be subject to Japanese withholding tax.

Third party debt that is guaranteed by an affiliate is not subject to the thin capitalisation rules.

The thin capitalisation rules provide a comparable company ratio exception, which is determined based on standards similar to those that should be used under a transfer pricing context. Under this exception, it is permissible to use a ratio that is higher than 3 to 1 if such ratio is also used by a specific Japanese corporation of similar size conducting similar business activities. It should be noted, however, that the Japanese tax authorities take a very strict position on the comparability exception.

Interest expense which is incurred for debt used to acquire shares in a domestic entity is not allowed as a deduction since the dividend is generally tax free. Funding costs incurred in acquiring foreign shares are, in principle, tax deductible, but subject to an adjustment in determining the foreign tax credit applicable to the relevant foreign-sourced dividend income.

(viii) Other Taxes

Japanese consumption tax (currently 5%) applies to goods sold and services rendered in Japan (excluding shares or securities but including goodwill). Export and certain services invoiced to non-residents are zero-rated. Consumption tax may be recoverable by the payers depending on their consumption tax recovery position. Typically it would not be recoverable for an individual who is not registered for consumption tax purposes. It may be only partially recoverable for a company in the financial sector and it may be fully recoverable for manufacturing or other service companies.

The security transfer tax has been abolished.

Stamp duty is payable on taxable documents with the maximum of ¥600,000 per document.

SALE OF SHARES OR ASSETS

In many situations, the Buyer or Seller will have conflicting interests regarding whether to structure a transaction as a sale of share or assets. Important considerations include the extent to which gain or loss will be recognised by the Seller on the disposition, the Buyer's willingness to increase the purchase price to achieve structuring objectives, and the Seller's after-tax investment return.

Because of Japan's relatively high individual and corporate tax rates, a sale followed by a liquidation or distribution of after-tax proceeds to the Seller may have a significant impact, depending upon the circumstances, the acquisition price and the structure of the transaction.

A Seller of a profitable business is more likely to be interested in selling shares, since this may mitigate the consequences of possible double taxation on gains at both the corporate and shareholder levels. However, where the Target has operating losses carry-forwards which are available to shelter gains on appreciated assets, a Seller may be willing to dispose of the assets of the Target.

In contrast, many Buyers want to purchase only selected assets or businesses to avoid issues such as acquiring hidden liabilities.

If the transaction is structured as a sale of shares, the Seller will be subject to income tax on the gain. If the transaction is structured as a sale of assets, the Target will be required to allocate the sales price among the assets for purposes of calculating the amount of the gain or loss.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profit on Sale of Shares

Gains realised on the sale of shares are included as income to the Seller and taxed at the normal tax rates (i.e. current combined effective tax rates of 42.05%). Neither stamp duty nor transfer duty is payable on the transfer of shares.

Gains derived by a foreign Seller on the disposition of shares of a Japanese company may not be subject to Japanese tax, if the Seller is a resident of a country with which Japan has a double tax agreement and such agreement exempts profit from sale of shares in a Japanese company from Japanese tax.

Gains derived by individual Sellers on the disposition of shares are taxable at the combined national and local individual tax rates of 26%. Individual Sellers who have losses in the same income category may deduct such losses against share gains in the same year. Individual Sellers may not generally carry forward losses. If the Target is a publicly traded company, an individual Seller who realises a gain on the sale of shares may elect to be taxed at a rate of 1.05% on the sale proceeds. (Note that recent tax reform proposals will eliminate this option. Tax Reform 2002 proposals are discussed below).

b) Distribution of Profits

Capital gains may be distributed as dividends to the shareholders without any restrictions. (See comments regarding Withholding Taxes and Taxation of Dividends under the section 'General Information').

c) Consumption Tax Does Not Apply to the Sale of Shares.

(ii) Buyer's Perspective

a) Acquisition Structure (Form and Location of Acquisition Co.)

Generally, an acquisition of a Japanese company is achieved through a direct acquisition by a foreign investor of the shares in the Japanese company. Where a Buyer intends to exit in subsequent years, it may wish to use an appropriate holding company in the USA, Netherlands, Switzerland or Germany as the Japanese tax treaties with these countries provide exemptions from Japanese tax on gains from the sales of shares in a Japanese corporation.

An acquisition of the Target's shares will permit the survival of any Japanese corporate tax attributes of the Target, including net operating losses carried forward. However, where a premium is paid to acquire shares, the goodwill arising from the purchase of shares is not amortisable to the Buyer for Japanese tax purposes.

The Target's tax basis in its assets remains unchanged in connection with a share purchase, as there is no change in the tax attributes of the Target. Further, there would not necessarily be any costs from the transfer of employees, which tend to be normal features of asset purchases. On the other hand, subsequent decisions made by the Buyer regarding personnel issues may be constrained by the Target's existing work rules, severance and retirement plans.

b) Funding Costs

Interest incurred by a Japanese company on funds that are used to acquire shares in another Japanese corporation is not tax deductible against the dividends paid by the Japanese corporation.

c) Acquisition Expenses

Acquisition costs incurred by a Japanese company with respect to the acquisition of shares in another Japanese corporation are also not tax-deductible in Japan. Such costs may be capitalised and deductible for tax purposes when the shares are sold.

d) Government Approval

No approval is required for a share acquisition, but such acquisition may be subject to anti-trust clearance and other approvals for operational licence, depending on the nature of business concerned.

e) Debt/Equity Requirements

See comments regarding Thin Capitalisation under the section 'General Information'.

f) Preservation of Tax Losses

Tax losses, unabsorbed tax depreciation and tax incentives stay with the Target after a share deal. If a company with tax losses is merged with another company, such tax losses may be carried over to that other company and used, subject to the net operating losses carry forward rules. However, it may be possible to step up the cost basis of the assets transferred to enable the other company to claim additional depreciation or amortisation on the increased cost basis. For a more detailed analysis of these two issues, see the section, 'Tax-Free Corporate Reorganisation Rules'.

g) Repatriation of Profits

See comments regarding Withholding Tax under the section 'General Information' on the implications relating to the payments of dividend, royalty, and interest.

The payments of royalty and interest will also be subject to the Japanese transfer pricing regulations (and thin capitalisation rules for interest).

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

a) Business Transfer

A business may be transferred from one entity in Japan to another by way of a sale of the assets and liabilities of the business (Business Transfer) at fair market value for Japanese tax purposes (FMV). The transferor company will record a profit or loss for Japanese tax purposes based on the difference between the proceeds received for the transfer and the book value of the assets/liability transferred. The transferee company will generally record the assets and liabilities at the FMV.

The difference between the transfer price and the FMV of the assets and liabilities in a business transfer would generally be treated as goodwill for Japanese tax purposes.

A payment received by the transferor company for goodwill would be included in its taxable profit, and may be set off against its accumulated net operating losses, if any. The transferee company would record the goodwill in its accounts and amortise the goodwill for tax purposes on a straight-line basis over a period of 5 years.

Where a transfer does not involve real estate, marketable securities or goodwill (to be discussed later), it may be possible to structure the business transfer so that most of the business assets are transferred at net book value without the recognition of taxable gain.

There is no distinction under Japanese corporate tax law between capital gains and ordinary income. In most cases, the tax and accounting basis of the assets will be the same, since there is a close degree of book and tax conformity.

Given the above, the following issues often arise in a business transfer:

<u>Issue 1</u> - The valuation of goodwill in related party transfers.

Under the Japanese tax laws, only the inheritance tax provides a method for calculating goodwill (i.e. not as a gap between the total business value and net book value). In practice, this method is often used for corporate income tax purposes as well. This method is used to calculate the 'excess earning' power that is represented by the excess portion of the average historical profit over a designated return on interest. It gives a low value for goodwill where the total tangible assets used for the business concerned are not small, and it could give some value for software or venture business due to smaller tangible assets.

For the valuation of total business value, other methods such as the market approach (e.g. PER) and comparables and their combination are often accepted by the tax authorities. The use of the discounted cash flow (DCF) method to determine the value of a business is less commonly used by the Japanese tax authorities, but it could be accepted if the DCF was computed preferably by an independent professional firm.

Since the calculation of goodwill involves the determination of the excess earning power, it is often difficult to justify the existence of goodwill with respect to a loss-making company. Furthermore, as the valuation of goodwill often involves subjective factors, the issue is often subject to dispute with the Japanese tax authorities.

Issue 2 - The calculation of FMV.

The basis for calculating the FMV of certain assets is summarised below. If these methods give an unreasonable result, other methods may be used:

- land and buildings - appraisal value determined by an authorised real estate appraiser. Otherwise, a value publicised by the government for purposes of the fixed assets tax or similar tax (known as Rosenka);
- depreciable assets - value determined by applying depreciation rates specified for Japanese tax purposes; and
- retirement reserves - a majority of Japanese companies provide accrued retirement allowances up to the tax-deductible limit that approximates 20% (currently 27% for 2001 and 23% for 2002 under tentative measures) of the full liability on a voluntary retirement base. However, Japan GAAP has recently implemented a similar principle used under FAS 87 which may differ from the deductible amount calculated based on the Japanese tax rules.

b) Consumption Tax

The Seller of assets is required to collect Japanese consumption tax (currently 5%) from the Buyer in connection with a sale of assets.

(ii) Buyer's Perspective

a) Acquisition Structure

Asset purchases in Japan may be more cumbersome and costly to the Buyer than share purchases, because of transaction taxes and filing procedures applicable to such acquisitions.

If the Target has assets the Buyer does not want to purchase, or has contingent or unrecorded liabilities, the transaction may be structured as an acquisition of specific assets or businesses. Although the rules are changing, Japanese accounting principles do not yet require extensive financial statement disclosures and permit, in certain situations, the recording of assets and liabilities off-balance sheet in the financial statements of non-consolidated subsidiaries. Accordingly, emphasis on pre-acquisition financial, tax and legal due diligence is necessary.

A Buyer may prefer to acquire assets, for example, where the Target does not have attractive tax attributes, such as carry-forward operating losses, or where the Buyer expects to be able to recover a significant portion of the consumption tax imposed on the purchase. In addition, a Buyer may also decide to acquire assets when there is an intention to integrate those assets into its existing business.

Under an asset deal, if a Buyer does not have a presence in Japan, it could form a domestic corporation (e.g. a KK) that would take over the business operation of the target company.

b) Funding Cost

The debt/equity ratio of the KK could be structured so that it is within the conditions stated under thin capitalisation rules (discussed above) to maximise the interest deduction.

Since the Japanese national and local tax rates are relatively high, the use of debt financing should reduce the Japanese tax to the KK.

c) Acquisition Costs

The cost of acquisition including professional fees, taxes and charges should, to the extent identifiable, be added to the cost of the relevant assets acquired. The tax treatments of these costs should then correspond with the tax treatments of the underlying assets (i.e. depreciable, amortisable or tax deductible when the assets are finally sold).

d) Cost Basis Step-Up/Treatment of Goodwill

The Buyer's basis in the Target's assets for Japanese tax purposes will determine the amount of allowable depreciation and the cost of goods sold that may be deducted for purposes of determining the Buyer's taxable income after the acquisition. The Buyer will take a cost basis in an asset acquisition. Therefore, the Buyer will be required to allocate the purchase price among the assets acquired for purposes of calculating future depreciation deductions.

If the Target's FMV, including any goodwill arising from the asset acquisition, exceeds the adjusted tax basis of its assets, an asset acquisition allows the Buyer to record the assets at their respective fair market values and obtain tax deductions for depreciation and amortisation.

See Seller's Perspective under the section 'Structuring An Asset Deal' for additional information relating to goodwill.

e) Consumption Tax

Japanese consumption tax is imposed on the transfer of assets (including goodwill) included in a business transfer. Consumption tax is not imposed on the transfer of monetary assets such as cash or receivables. However, consumption tax paid by the transferee may be recovered, depending on the transferee's tax position.

SHARE-FOR-SHARE EXCHANGES AND TRANSFER

Under a stock-for-stock exchange, the issued and outstanding shares held by shareholders of a company that will become a 100%-owned subsidiary (BCo) will be transferred to a company that will become the 100% parent company of BCo (ACo). ACo will issue new shares to BCo's shareholders in exchange for the shares in BCo.

Under a stock-for-stock transfer, shares of a company that will become a 100%-owned subsidiary (BCo) which are held by BCo's shareholders will be transferred to another newly established company (ACo). ACo will issue new shares to BCo's shareholders so that ACo will become the 100% parent company of BCo.

The capital gain that would have been be realised by the shareholders of BCo on the transfer of BCo's shares pursuant to a stock-for-stock exchange or transfer for tax purposes will be deferred, provided the following conditions are satisfied:

- ACo reports the shares obtained from the former BCo shareholders at an amount that is equal to or less than the total book value of the shares that were held by the BCo shareholders prior to the stock-for-stock exchange or transfer.
- The total amount of ACo shares that the BCo shareholders should receive as a result of the stock-for-stock exchange or transfer should be at least 95% of the consideration.

If the number of shareholders in BCo is 50 or more, the book value of the BCo shares that must be recorded by ACo in its books is the book value of the net assets of BCo immediately before the stock-for-stock exchange or transfer.

When cash or other assets are paid to the BCo shareholders at the time of the stock-for-stock exchange or transfer, gain or loss would be recognised. The amount of the gain or loss is equal to the amount of the cash or other assets (at their fair market value) received less the book value of the shares transferred that may be allocated to the cash or other assets received.

TAX-FREE CORPORATE REORGANISATION RULES

(i) Intoduction

The corporate reorganisation rules are effective for reorganisations completed on and after 1 April 2001. Under the rules, assets and liabilities may be transferred at book value provided that certain conditions are met. As a result, the capital gain or loss that would have been realised on the transfer will be deferred.

The corporate reorganisation rules apply to the following types of reorganisations:

- Qualified corporate spin offs and split ups;
- Qualified investment (contribution) in kind;
- Qualified post establishment transfers; and
- Qualified mergers.

(ii) 100% Ownership in Subsidiary

A transfer of a business unit to a new or existing wholly-owned subsidiary in return solely for shares/stock in the subsidiary may be accomplished on a tax-free basis. No other tests need to be satisfied.

(iii) More than 50% Ownership in Transferee Corporation

Tax-free transfers of a business unit to a less than 100%-owned subsidiary may be accomplished if the transferor owns more than 50%, directly or indirectly, in the transferee corporation and the following conditions are satisfied:

- Transfer of Business Unit – it is expected that about 80% or more of the employees in the transferred business unit will continue to be engaged in the transferred business at the transferee corporation;

- Continuing Business Requirement – the business that is transferred will continue to be operated by the transferee corporation after the transfer; and
- The principal part of the business assets and liabilities used in the transferred business unit will be transferred to the transferee corporation.

(iv) Joint Business Reorganisation (50% or less ownership)

In the case of a reorganisation between two companies that share a group relationship of less than 50% (a joint business reorganisation), the reorganisation may still be treated as a qualified reorganisation if the following conditions are satisfied:

- the conditions for a tax-free transfer applicable to a more than 50%-owned subsidiary as stated above are satisfied;
- Continuing Shareholding Requirement – in general, more than 80% of the former shareholders of the transferor corporation must continue to hold the shares of the transferee corporation;
- Business Relevancy Requirement – the business transferred by the transferor and one of the businesses of the transferee must be 'relevant' to each other; and
- Comparable Business Size Requirement – either (a) or (b) below must be satisfied:
  a) the ratio of either sales, number of employees, or other appropriate measure, of the transferred business unit and the transferee's relevant business must be no greater than 5:1.
  b) if (a) above cannot be met, this condition will still be satisfied if the transferor corporation sends at least one of its management-level person to the management of the transferee corporation.

(v) Investment-in-Kind

An investment-in-kind, or contribution to capital, which generally meets the above conditions may be accomplished on a tax-free basis. Under this scenario, an entire business unit need not be transferred, but single assets can be transferred as a contribution to capital on a tax-free basis if it is made to a wholly-owned subsidiary. Transfers to less than 100% affiliated companies can be made tax-free if the transfer is of a business unit, and the requirements discussed above are satisfied. (See 'More than 50% Ownership in Transferee Corporation' or 'Joint Business Reorganisation (50% or less ownership)' under the section, 'Tax-Free Corporate Reorganisation Rules').

(vi) Post-Establishment Transfer

Under a post-establishment transfer, the transferor corporation first incorporates a new corporation (transferee corporation) via a cash contribution and the transferee corporation then uses the cash to purchase the transferred assets. This transaction may be accomplished tax-free if the following conditions are satisfied:

- the transferor company held all of the outstanding shares of the transferee company throughout the period up to and including the asset transfer;
- the transferor company expects to continue to hold the shares of the transferee company;
- the assignment of assets was planned at the time of the establishment of the subsidiary, and the assets were actually transferred within 6 months from the establishment of the subsidiary; and
- the amount of cash paid to the transferor company is approximately the same as the amount contributed by the transferor company to the transferee company.

(vii) Merger

In general, a tax-free merger may be accomplished if the above-mentioned conditions are satisfied. No step-up in basis is allowed in a tax-free merger under the new rules. All assets and liabilities of the merged company are transferred to the surviving company at book value. Thus, no gain or loss will be recognised with respect to the merger. There will be no deemed dividend recognised with respect to the liquidation of the merged company. Note that a cancellation loss on the merged corporation shares held by a merging corporation at the time of the merger will not be tax deductible.

Thus, the merger will be tax-free if:

- the merger of 100% affiliated Group companies is solely for stock;
- the merger of more than 50% but less than 100% affiliated companies meets the conditions in the above paragraph entitled, 'More than 50% Ownership in Transferee Corporation'; or
- the merger of less than 50% affiliated companies meets the conditions in the above paragraph entitled, 'Joint Business Reorganisation (50% or less ownership)'.

(vii) Restriction of Using Carried-Over Losses

In general, only net operating losses (NOL) incurred within 5 years may be transferred to the transferee in a Qualified Merger. NOL which arose before the loss company became a Group Member are generally not allowed to be used unless a 'Joint Business Test' is satisfied.
On the other hand, the use of NOL is not restricted in a Qualified merger under a Joint Business Reorganisation. In the case of Spin Offs, Split Ups (except for Split Ups which may be regarded as merger equivalent), or contributions in kind, the NOL will remain with the transferor corporation.

OUTLINE OF TAX REFORM OTHER THAN FOR CORPORATE REORGANISATIONS

(i) Taxation of Capital Gains to Individuals

Reforms relating to the taxation of gains on the sale of listed shares have been proposed with a view towards stimulating the stock market in Japan.

Under the reforms, the option to pay withholding tax at the rate of 1.05% of the sales proceeds will be abolished from 1 January 2003, instead of from 1 April 2003. In addition, the tax rate on gains realised by individuals from the sale of shares will be reduced from 26% to 20%, effective from 1 January 2003. For shares that are held for more than 1 year and sold between 1 January 2003 and 31 December 2005, a 10% tax rate will be imposed. Additional proposals relating to the taxation on the sale of shares including a carry-forward of capital losses for 3 years have also been suggested.

(ii) Consolidated Tax Return System

The consolidated tax system will be effective for accounting years commencing on or after 1 April 2002. The consolidated tax system will apply to Japanese parent companies and their 100% Japanese subsidiaries. Adoption of the consolidated tax system is optional but it has to be continuously applied once elected, and all of the 100% subsidiaries are subject to consolidation without any selection of the subsidiaries. The corporate national income tax rate is basically the same as the normal rate (currently 30%), but a surplus tax will be imposed at 2% for the initial 2 years.

Parent companies should file tax returns and pay taxes on the consolidated corporate income. The system applies only to the national corporation tax. The local inhabitant taxes and local enterprise tax will continue to be imposed on each member company.

The parent company and its subsidiaries will be jointly and severally liable for tax liability. Tax allocation will be made according to (and limited to) each company's taxable income or tax liability. The parent company will pay the tax on behalf of the entire group and later seek tax reimbursement from its subsidiaries, or record it as a credit on its books until receipt of payment from the subsidiaries.

The recognition of profits or losses from intra-group transactions will be deferred until the assets are transferred to a party outside the consolidated group, when the consolidated group dissolves, or when a member company withdraws. However, this rule will not apply to transfers of inventory (i.e. no deferral of recognition of profits or losses is allowed).

Tax net operating loss (NOL) incurred before adoption of the consolidated tax filing or before participation in the consolidated group may not be utilised under the tax consolidation system, except for the NOL of the parent and the NOL of certain subsidiaries in very limited circumstances.

Immediately before consolidating (or after joining a group), subsidiary companies will generally be required to separately recognise gains/losses and pay tax on the built-in gains. This rule will not apply to the parent company or to subsidiaries that have been associated with the parent for a certain period. This rule will not apply to companies joining the group under a tax-qualified reorganisation.

EXIT STRATEGIES

(i) Sale of Shares

Capital gains derived by a foreign corporation from the transfer of shares in a Japanese corporation are subject to Japanese corporate tax at the regular rates if the foreign corporation transferred at least 5% of the shares in the Japanese corporation in an accounting period and the foreign corporation owned at least 25% of the shares in the Japanese corporation at any time during the three-year period before the end of the accounting period in which the transfer was made (quasi-business transfer). However, the gain may be exempt from Japanese tax under certain tax treaties. For example, resident corporations of the Netherlands, Switzerland, the United States and Germany are exempt under tax treaties from Japanese tax on capital gains derived from the transfer of shares in a Japanese corporation, unless the gains are attributable to a fixed place of business (PE) in Japan of the shareholder (i.e. if the shareholder held the shares through its Japanese branch).

(ii) Initial Public Offer (IPO)

There are no special tax laws or regulations applicable to capital gains arising from an IPO in Japan.

(iii) Profit Repatriation

Generally, it is tax effective for the Target to remit payments overseas to the Buyer or its affiliates in the form of tax-deductible payments, such as interest, royalties, cost of goods sold, or payment for services, rather than in the form of dividends that are not tax-deductible in Japan. However, such payments are generally subject to scrutiny for transfer pricing purposes. In addition, the recipient should ensure that the services provide do not result in it having a permanent establishment in Japan.

ENDING REMARKS – PREPARATION FOR A DEAL

Japan has many different kinds of taxes and regulations which are applicable to merger and acquisition deals. Thus, it is important for a party to any merger or acquisition to ensure that these taxes and regulations are being complied with.

(i) Foreign Exchange Control Laws

Japan's Foreign Exchange Control Law provides that foreign investors, including Japanese companies in which 50% or more of the shares are held by non-residents, or companies incorporated under foreign laws, must report all inward direct investment to the appropriate authorities within 15 days of making the investment. This is not for an approval process but only for reporting purposes.

(ii) Japanese Commercial Code

Formation of a company by way of contribution of assets in kind is generally subject to review by an inspector who is appointed by the court (Kensayaku) under the Japanese Commercial Code. Likewise, the Japanese Commercial Code provides restrictions on the ability of Buyers to purchase business assets through a newly-formed Japanese company. Business asset acquisitions which involve a newly-formed Japanese company could be subject to the same court-appointed inspector requirement. These procedures may take time and delay the implementation of asset acquisitions.

(iii) Japanese Anti-Monopoly Law/Consolidated Tax Filing

The recent changes to Japan's Anti-Monopoly Law no longer prohibit the use of holding companies in Japan. Since the Japanese tax rules were recently revised to include consolidated tax reporting, there are incentives associated with the use of domestic holding companies by foreign investors.

(iv) Japan's Ministry of Finance

Japan's Ministry of Finance has broad discretionary authorities over many aspects of Japan's financial markets, and the interpretation of laws relevant to financial institutions. As a result, tax planning techniques which may be reasonable and appropriate for non-financial services entities may not be possible for financial institutions without prior Ministry of Finance approval.

KOREA

Country M&A Team

Country Leader ~ Ando Yun
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SECTIONS

General Information
Structuring a Share Deal
Sructuring an Asset Deal
Exit Route
Ending Remarks
– Preparation for a Deal

GENERAL INFORMATION

(i) Introduction

A corporation formed under Korean laws is subject to Korean tax on its worldwide income. However, a credit for foreign tax paid or deduction is allowable in respect of the foreign sourced income.

A branch of a foreign corporation is subject to tax on its income generated in Korea.

Korea has specific tax provisions dealing with transfer pricing rules, anti-thin capitalisation and anti-tax haven.

(ii) Common Forms of Business Entity

The following forms of business entity are available in Korea. However, Chusik Hoesa is by far the most common form of business entity although recently Yuhan Hoesa has been used by some US companies as it may be used to benefit from 'check-the-box' rule under the US tax code.

a) Chusik Hoesa

Chusik Hoesa (CH) is the only Korean business organisation permitted to issue shares or bonds publicly and therefore, is the most common form of business entity used in Korea.

b) Yuhan Hoesa

A Yuhan Hoesa (YH) is an incorporated enterprise whose shareholders' liability is limited to the amount of contributed capital. A YH may not issue debentures to the public. In most other respects, the formation, structure and conduct of a YH are similar to those of a CH.

One possible advantage of using a YH is that it may be possible to obtain 'flow-through' tax treatment in a foreign jurisdiction (such as the US). For example, at present, a Korean YH may be eligible to 'check-the-box' under U.S. tax regulations, thus making it a partnership or 'disregarded' entity for U.S. tax purposes. By contrast, a Korean CH is on the list of 'per-se corporations' under the U.S. regulations, and is thus not eligible to check-the-box for U.S. tax purposes.

c) Hapmyong Hoesa (Partnership)

A Hapmyong Hoesa is organised by two or more partners who bear unlimited liability for the obligations of the company. Professionals in practice, such as certified public accountants and lawyers, use this form of entity to conduct their business. Hapmyong Hoesa itself is subject to corporate income tax.

d) Hapja Hoesa (Limited Partnership)

A Hapja Hoesa consists of one or more partners having unlimited liability and one or more partners having limited liability. The former bears unlimited joint liability for the obligations of the company, while the latter is limited to the amount of contributed capital. Hapja Hoesa itself is subject to corporate income tax.

(iii) Foreign Ownership Restrictions

Foreign investors may invest in most industries without any ownership restrictions. However, for a few industries such as newspaper and magazine publishing, telecommunications and cable broadcastings, the Korean government encourages foreign investors to establish a joint venture company with Korean partners rather than a wholly-owned subsidiary by restricting the amount of foreign ownership to a certain designated percentage.

(iv) Tax Rates

a) CorporationTax

The corporation tax rates are as follows:

Tax base	Corporation tax (%)	Resident surtax (%) *	Total (%)
KRW 0 - KRW 100 million	15	1.5	16.5
Over KRW 100 million	27	2.7	29.7

* Resident surtax is a local tax which is levied at 10% of corporation tax.

b) Branch Profit Tax

If the tax treaty between Korea and the country of which the foreign corporation is a resident allows imposition of a branch profit tax, the tax is imposed on the adjusted taxable income of the Korean branch of the foreign corporation. Branch profit tax will be imposed at 5% – 25 % on the adjusted taxable income of a foreign corporation. The branch profit tax rates under the treaty are as follows:

Country	Tax rates (%)
Canada	15
France	5
Australia	15
Indonesia	10

Country	Tax rates (%)
Philippines	10
Brazil	15
Morocco	5
Kazakhstan	5

The adjusted taxable income is calculated by subtracting the regular corporation tax and the surtax from the taxable income. Where the net worth at the end of a taxable year exceeds the net worth at the beginning of the taxable year, then the excess amount should be subtracted from the taxable income.

c) Withholding Tax

A corporation which pays Korean-source income to a foreign corporation which does not have a Permanent Establishment (PE) in Korea should withhold corporate income tax and resident surtax at the time of payment. The withheld taxes should be paid to the tax office through a commercial bank within 10 days after the close of the month during which the withholding was made. Unless reduced by an applicable double tax treaty, the rates of withholding tax for various types of income are as follows:

Type of income	*Withholding tax rate*
• Interest, dividends, royalties or other income	27.5% of the amount paid
• Rental income from ships, aircraft or registered heavy equipment, or business income	2.2% of the amount paid
• Income from personal services	22% of the amount paid
• Gains on transfer of securities or bonds	Lesser of 11% of the compensation received, or 27.5% of the gain on the transfer

(v) Taxation of Dividends

Dividend income received by a company constitutes taxable income of the company.

However, a qualified holding company under the Free Trade Act (FTA) that owns 50% (30% in the case of listed subsidiary) or more of the equity in its subsidiary will be allowed a deduction equivalent to 60% to 100% of the dividend received.

A normal company which is not a qualified holding company under the FTA will be allowed a deduction equivalent to 30% to 50% of the dividend received if certain conditions are met.

In order to prevent a holding company and a normal company from expanding the control over subsidiaries through borrowings, the more the holding company and the normal company have borrowings and interest costs, the less the dividend (received) deduction is allowed.

The dividends do not carry the underlying tax credit. Thus, shareholders are taxed on the dividends with no credit being allowed in respect of any underlying tax paid by the subsidiaries.

Dividend income paid by a Korean company to a non-resident is subject to withholding tax which is to be deducted by the Korean payer from the gross payment.

(vi) Tax Losses Carry-Forward/Carry-Backward

In general, tax losses may be carried forward for 5 years without having to satisfy any test. Carry-backward of tax losses is generally not allowed except for small and medium sized companies for which losses may be carried backward for 1 year; however, tax losses arisen or arising in fiscal years 2001 and 2002 may be carried backward for 2 years.

(vii) Thin Capitalisation

Effective 1 January 1997, Korean subsidiaries or branches of foreign companies (including permanent establishments) face restrictions on the level of deductible interest with respect to borrowings from overseas controlling shareholders (OCS). The so-called 'thin capitalisation' rules also apply to third party loans guaranteed by OCS.

Generally, the ratio of debt-to-equity for loans received from the OCS (including relevant guarantees) may not exceed 3:1 (6:1 for certain financial institutions), unless certain conditions are met. If the taxpayer can prove that the level of the debt and related terms and conditions are similar to those of comparable companies that borrow from unrelated third parties, a higher ratio may be allowed.

The amount of disallowed interest expense is calculated based on a specific formula which takes into account the total corporate borrowing, related party (OCS) borrowing, and level of equity in the Korean borrower. Any disallowed interest expense may be re-classified as a deemed dividend or other type of income to the recipient and subject to Korean tax accordingly.

The following interest expense may also be disallowed:

a) Disallowance of interest expense for excessive borrowings over 400% of capital (1,500% for some financial institutions).

This legislation applies to listed companies (except for small and medium sized company) and companies whose net assets exceed KRW 100b. The restriction may be waived if:

- the interest expense for the year is 3% or less of the amount of sales for the year;
- the interest expense for the year is 40% or less of the amount of taxable income for the year; or
- the amount of excess borrowings for the year has decreased by 20% or more as compared to that of the prior year.

b) Disallowance of interest expense for investment in certain companies

If a Korean company has borrowings in excess of two times its equity and owns the following types of assets, a portion of its interest expense would generally be disallowed for tax purposes:

- shares in other corporations; and
- certain forest land, farm land, and stock farm land used for certain purposes.

c) Disallowance of interest expense for holding non-business purpose assets

Where a corporation owns the following assets and has any borrowings, a portion of interest expense may be disallowed for tax purposes:

- real estate which is regarded as not being directly related to the business of the company, or which is deemed to be owned for speculative purposes;
- certain other assets which are regarded as not being directly related to the business of the company (e.g. antiques, paintings, etc.); and
- certain non-business purpose loans or advances extended to corporations or individuals related to the company.

For those corporations seeking tax incentives, the relevant authorities may set a minimum capital amount.

(viii) Other Taxes

a) Acquisition Tax and Registration Tax on Acquisition of Properties (local taxes)

A purchaser of taxable properties (land, building, some machineries, etc.) is required to pay acquisition tax and registration tax at the time of purchase. The acquisition tax (including surtax) ranges from 2.2% to 11% and the registration tax (including surtax) ranges from 0.48% to 3.6%.

The tax rate could increase (three times or five times) for acquisition of discouraged properties (e.g. properties acquired for non-business purpose) or for properties located in a metropolitan area.

The acquisition tax could also be imposed on a purchaser of shares in a company whereby share-ownership of the purchaser becomes 51% or more.

b) Securities Transaction Tax

If shares in a Korean company are transferred, a security transaction tax of up to 0.5 % may apply (based on the fair market value of the shares transferred). This tax should generally be paid by the seller and should apply even if the transfer is a share exchange between foreign companies. There are certain cases where a transferor may be exempt from the tax or be subject to a lower rate. To the extent the fair market value of the shares is not readily ascertainable, value may be assessed in accordance with the Inheritance and Gift Tax Law.

c) Value Added Tax

Value Added Tax (VAT) is imposed on the supply of taxable goods or services at 10% of the supply price. The VAT paid by purchaser of taxable goods or services may be claimed (except certain cases) by the purchaser as input VAT. In general, for goods or services exported, the VAT is zero rated.

(ix) Tax Incentives for Foreign Investment

Foreign invested corporations may be entitled to tax incentives if they are involved in inducement of advanced technologies or industry supporting services, as defined, or are located in a designated Foreign Investment Zone or the investment is of one that is designated by Presidential Decree as being essential to induce foreign investments. The incentives may include exemption from and reduction in income tax, acquisition tax, registration tax, property tax and aggregate land tax, exemption from customs duties, special excise tax and VAT on capital goods imported and withholding tax exemption on payment of royalties to a foreign supplier of technology.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Capital Gains Taxes

A domestic corporate shareholder, including a taxable PE or branch of a foreign person, will generally be subject to the corporate income tax rate of 29.7% on gains derived from the sale of shares in a Korean entity. The capital gain is generally calculated as the difference between the acquisition cost of the shares and the fair market value of sales proceeds received in the exchange. The securities transaction tax paid will be deducted from the sales proceeds of the shares for the purpose of calculating the capital gain.

Under Korean domestic tax laws, non-resident foreign shareholders' capital gains on the sale of shares in a Korean company are generally subject to income tax (by way of withholding) at the lesser of 11% of the gross proceeds received or 27.5% of the capital gain.

However, effective from 1 January 2000, gains derived from the sale of shares in a Korean company are not subject to Korean tax if a foreign transferor meets the following conditions:

- the foreign transferor does not have a Permanent Establishment in Korea;
- the shares being transferred are publicly listed; and
- the foreign transferor did not own 25% or more of the shares of the publicly listed entity during the last 5 years.

b) Securities Transaction Tax

Under a share deal, a security transaction tax of up to 0.5 % may apply (based on the fair market value of the shares transferred). This tax shall generally be paid by the seller and applies even if the transfer is a share exchange between foreign companies. There are certain cases where a transferor may be exempt from the tax or subject to a lower rate. To the extent the fair market value of the shares is not readily ascertainable, value may be assessed in accordance with the Inheritance and Gift Tax Law.

(ii) Buyer's Perspective

a) Acquisition Structure

Acquisition of shares in a target company may be in the following forms:

- Purchase of existing shares from existing shareholders by foreign investors

  A foreign investor may purchase shares in a target company from existing shareholders. The consideration for the share transfer would be paid to the existing shareholder who would be subject to capital gains tax in Korea on the gains. If the share-ownership of the foreign investor becomes 51% or more of the target company, the foreign investor would be subject to acquisition tax as explained above.

  A foreign investor would not be eligible for tax incentives under a share deal.

- Purchase of new shares of the target company by foreign investors

  The foreign investor may increase its share-ownership by exclusively participating in issuance of new shares of the target company. The acquisition tax may also apply in this case. This type of foreign investment may be eligible for tax incentives applicable to foreign investment.

- Purchase of shares in a target company through a holding company.

  Effective from 1 April 1999 a foreign investor may set up a holding company in Korea to purchase existing shares or new shares in a target company.

  However, the investment by a holding company in a target company will not be treated as foreign investment. As such the target company may not be eligible for tax incentives available to foreign-invested corporations.

  The holding company structure is more commonly used by local investors so as to reduce the tax liability on dividends received from a subsidiary. For an overseas investor, it would be more tax efficient to own a target company through an overseas holding company: this would only subject the dividends paid by the target to withholding tax.

- Deductibility of funding cost

  Where a foreign buyer incurs interest cost on a direct acquisition of a Korean target, a tax deduction is not allowed against dividends received by the buyer.

- Preservation of tax losses and tax incentives

  In the case of a share deal, existing tax losses and tax incentives granted to the target company are maintained even after the deal.

- Government approval requirements

  Purchase of shares in a Korean company by a foreign investor should be reported to the Ministry of Finance and Economy (or to a bank) in advance of the purchase.

STRUCTURING AN ASSET DEAL

Buyers often prefer an asset deal to a share deal, primarily to minimise the business, legal, and financial risk of acquiring a company with cross-guarantees, uncollectible receivables, contingent liabilities, and a host of other unknowns. Furthermore, when assets are acquired rather than shares, the buyer may be able to step up the basis of the assets to fair market value and to amortise goodwill resulting from the transaction over a period of 5 to 20 years. Additionally, where a foreign acquirer is in a designated high-tech industry (or certain other target industries), the investment in new shares of a subsidiary company may be eligible for various tax incentives. Such incentives are not generally available in the case of an acquisition of existing shares in a Korean company.

The term 'business transfer' used in this section means 'a comprehensive transfer of all the rights and obligations of a transferor related to the business' as defined under the Presidential Decree of the Basic National Tax Law. In the case where a transferee acquires only a portion of the target business assets or liabilities, it is usually called an 'asset transfer' in order to differentiate from a 'business transfer'. However, in many cases it may be difficult to clearly differentiate between an 'asset transfer' and a 'business transfer.'

(i) Seller's Perspective

a) Corporate Income Tax on Capital Gains

Corporate income tax will generally apply to any taxable gains realised by the seller in a business transfer. The applicable tax rate will be the regular corporate income tax rate.

b) VAT

Generally, the seller in a 'comprehensive business transfer' is not required to charge VAT for the assets transferred to the buyer, because a 'comprehensive business transfer' is not generally regarded as a supply of goods for VAT purposes.

However, in the event that a buyer acquires only a portion of the target business assets or liabilities (asset transfer), the transfer may be subject to VAT.

c) Corporate Income Tax on Liquidation Income

If, after a business transfer, the transferor company is liquidated, the liquidating company may be subject to corporate income tax on the 'liquidating income'.

d) Deemed Dividends

When a corporation is liquidated and the remaining assets are distributed to shareholders, to the extent the proceeds received by a shareholder exceed the acquisition price for their shares, the shareholder would be deemed to receive the excess as dividend.

Korean corporate shareholders must include such deemed dividends when calculating their taxable income.

Foreign corporate shareholders will be subject to Korean withholding tax on the deemed dividends (assuming the dividend is not connected with a PE of the foreign shareholder in Korea). The rate of withholding on such dividends under Korean domestic law is 27.5%. However, the tax rate may be reduced under an applicable double tax treaty between Korea and the resident jurisdiction of the foreign shareholder.

(ii) Buyer's Perspective

a) Acquisition Tax

The acquisition tax ranging from 2.2% to 11% of the price of the assets tranferred such as real estate, vehicles, certain construction equipment, aircraft, vessels, mining rights, golf memberships and health club memberships would generally be imposed at the time of acquisition.

b) Registration Tax

Registration tax ranging from 0.48% to 3.6% of the value of assets registered such as real estate, vehicles, certain construction equipment, aircraft and newly issued share capital, would be imposed at the time of registration of a change in ownership.

c) Exemption or Reduction of Registration Tax or Acquisition Tax

Certain local governments may grant exemptions or reductions of registration tax and acquisition tax arising in the course of a comprehensive business transfer. If a transferee of a business is exempted from registration and acquisition taxes in accordance with the local government's ordinance, only the Special Tax for Rural Development shall be paid at the rate of 20% of the amount of the exempted registration and acquisition taxes.

d) Asset Value Step-Up/Treatment of Goodwill

If a comprehensive business is purchased at fair market value, the acquisition cost of the target business assets may be stepped up (or down, as the case may be) to fair market value. If the transferee pays consideration in excess of the fair market value of the net target business assets acquired, the excess will be regarded as goodwill. For tax purposes, goodwill may be amortised in accordance with the accounting amortisation which is over 5 years or longer (but not more than 20 years) using the straight-line method.

e) Secondary Liability for Taxes in Arrears

The acquirer of a complete business (comprehensive business transfer) bears secondary tax liability for national taxes, penalty taxes, interest on deferred payments and expenses for collection of such taxes, as well as local taxes, but only to the extent the business transferor's liability for such taxes was fixed as at the date of the business transfer. Additionally, the secondary tax liability is limited to the value of assets transferred and the amount of the aforementioned taxes, penalty taxes, interest and expenses that remain after appropriating the transferor's own property to pay the taxes in arrears. Therefore, the potential purchaser of a comprehensive business should confirm with the relevant tax authorities whether the transferor has any tax liabilities in arrears before proceeding with the business purchase.

In the event that a transferee acquires only a portion of the target business assets or liabilities (asset transfer), then the transferee may not be subject to secondary tax liability.

EXIT ROUTE

The Korean government has in recent years open up its economy to encourage foreign investments. Before entering a deal to acquire an investment in Korea, a foreign buyer would need to consider its investment strategies and if applicable, the exit strategies.

As indicated above, an asset deal will result in a host of tax issues to the seller whereas a share deal may be structured more tax effectively.

Korea has a comprehensive network of double tax treaty. For example, under the Malaysia and Korea treaty, a gain on disposal of shares in a Korean company earned by the Malaysian shareholder would not be subject to Korean tax. In addition, under the Malaysia domestic law such gain should also not be subject to tax in Malaysia.

Therefore, by selecting an appropriate buying entity for a Korean target, a foreign investor may exit Korea with relatively reduced tax cost.

ENDING REMARKS – PREPARATION FOR A DEAL

Korean commercial and tax laws relating to mergers and acquisitions are complex. To ensure a smooth process, both seller and buyer would need to know all the relevant legislations affecting their deal. A mismanaged deal will not only increase the cost due to, inter alia, inefficient tax planning but may also result in non-compliance of statutory requirements.

To manage the downside and capitalise on the upside (e.g. obtaining tax incentives and concessions), careful planning is required.

MALAYSIA

Country M&A Team

Country Leader ~ Frances Po
Peter Wee
Angela Chin

SECTIONS

GENERAL INFORMATION

(i) Introduction

Malaysia operates a unitary tax system on a territorial basis. Tax residents of Malaysia, whether corporate or individuals, are taxed on income accruing in or derived from Malaysia. Resident companies are exempted from income tax on foreign-sourced income remitted to Malaysia, except for those carrying on banking, insurance, sea or air transport operations as those companies are taxed on a world-wide basis. Non-residents are only taxed on income accruing in or derived from Malaysia.

(ii) Common Forms of Business Entity

The principal form of business enterprise in Malaysia is public or private company incorporated with the Registrar of Companies under the provisions of the Companies Act. Partnerships and sole proprietorships, which are unincorporated, must be registered with the Registrar of Businesses.

(iii) Foreign Ownership Restrictions

Generally, foreign direct investments are encouraged in Malaysia. However there are certain restrictions on the permitted level of foreign participation for different types of industry. Full foreign ownership is permitted for certain industries such as manufacturing companies having export levels of more than 80%. Other entities are required to have at least 70% Malaysian shareholders.

(iv) Tax Rates

a) Corporate Tax

The corporate tax rate for resident and non-resident corporations is 28%. From the year 2000, the basis of income assessment has been changed from preceding year to current year. A self-assessment system of taxation has been introduced in stages, starting with companies, in the year 2001.

b) Branch Profits Tax

There is no branch profits tax in Malaysia. Permanent establishments operating in Malaysia are subject to corporate tax at a rate of 28%.

c) Withholding Tax

Cross border payments

The Malaysian income tax legislation provides for withholding tax to be deducted at source on certain payments made to non-residents. The withholding tax rates are as follows:

	Non-Treaty Rate %	Treaty Rate %
Interest	15	0-15
Royalty	10	0-10
Management/Technical fees	10	0-10
Rental of moveable properties	10	0-10

Appropriate double tax treaties may reduce the withholding tax rates. Malaysia has a comprehensive network of double tax treaties.

Malaysia also imposes withholding tax on payments made to non-resident contractors in respect of services rendered in Malaysia at the following rates:

- 15% of contract payment on account of tax which is or may be payable by the non-resident contractor; and
- 5% of contract payment on account of tax which is or may be payable by employees of the non-resident contractor.

(v) Taxation of Dividends

Malaysia has an imputation system of taxing dividends. The ability of a company to pay dividends to a shareholder depends on the availability of tax franking credits (Section 108 credit) and its distributable profits. If the company does not have sufficient franking credits (which is the amount of income tax paid by the Company less the amount already used to frank payments of dividends), any dividend paid would be subject to tax at the current rate of 28%. Such tax paid is not creditable against any future tax liability of the company. Exempt income, for example, offshore income or pioneer income derived by the company may be distributed to the shareholders without having to satisfy the abovementioned franking requirement.

There is no withholding tax levied on dividends paid by a Malaysian company. Under the imputation system as stated above, Malaysian-sourced dividends received by shareholders are deemed to have suffered tax at source at the corporate tax rate (currently 28%) by the paying company. If there are expenses incurred in deriving such dividends, these expenses are tax deductible and may result in the shareholders receiving a tax refund. Where dividends are paid out of tax-exempt profits, such dividends are not subject to tax in the hands of shareholders.

(vi) Tax Losses and Tax Depreciation

Tax losses not utilised in a particular year may be carried forward for set-off against future business income. There is no provision for loss carry-back in Malaysia. Unutilised tax depreciation on qualifying capital assets is only deductible against the adjusted income from the same business source. Any unabsorbed tax losses and unutilised tax depreciation may be carried forward indefinitely and is not denied by a change in ownership.

(vii) Thin Capitalisation

There are currently no thin capitalisation rules in Malaysia. However, a debt/equity requirement may be imposed by the Malaysian Central Bank for exchange control purposes.

(viii) Other Taxes

a) Real Property Gains Tax

Capital gains are generally not taxable unless the gain is in respect of a disposal of real property situated in Malaysia or shares in a real property company (RPC). These taxable capital gains are subject to real property gains tax payable by the vendor, at reducing scale rates ranging from 30% to 5%, depending on the period of ownership. A RPC is a controlled company, the major assets of which consist substantially of real property or RPC shares.

Specific exemption from real property gains tax is available provided the stipulated conditions are met. For example, exemption may be granted if it can be clearly shown that the transfer of property between group companies results in increased operational efficiency (and for consideration consisting substantially of shares) or where an asset is transferred in any scheme of reorganisation or reconstruction in compliance with Government policy on capital participation in industry. Approval for exemption must be secured prior to the disposal date.

b) Indirect Taxes

Malaysia does not have a comprehensive value added tax or goods and services tax. However, the following taxes or duties are imposed on goods and services. One or more of the following types of duty and tax could be imposed in relation to goods:

- customs duties at specific rates, or, at ad valorem rates (up to 300%) on dutiable goods imported into Malaysia;
- sales tax at specific rates or at ad valorem rates (5%, 10%, 20% or 25%) on taxable goods that are manufactured in, or imported into, Malaysia; and
- excise duties at specific rates or at ad valorem rates (up to 65%) on goods subject to excise duty that are manufactured in Malaysia.

In relation to services, a service tax is chargeable on taxable services provided by taxable persons, except exported taxable services. The taxable services and taxable persons are prescribed by way of regulations. The rate of service tax is generally an ad valorem rate of 5%.

c) Stamp Duty

Malaysia imposes stamp duty on instruments for effecting certain transactions.

The stamp duty rates are as follows:

Transfers of shares	0.3%
Transfers of properties	between 1% - 3%

Specific exemptions from stamp duty are available provided stipulated conditions are met. For example, in transfers involving companies which are at least 90% related or where the consideration for transfers is satisfied by issuance of at least 90% of shares in the transferee company.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profits on Sale of Shares

Unless the Seller is in the business of dealing in shares, the profits on the sale of shares should not be subject to income tax as such profits would be of a capital nature. The only exception is where the shares are RPC shares and the gains from the disposal thereof are thus subject to real property gains tax.

b) Shareholders Loan

Where the vendor transfers its inter-company debts due by a target at cost, such transfer would be regarded as capital transaction and is tax neutral to the vendor. For the buyer who acquires the inter-company loan, the purchase price of the shares in target would be reduced but the debts taken over that subsequently turns bad will generally not be tax-deductible to the buyer.

If the vendor forgives its inter-company debts due by a target, the taxation implication would depend on the nature of the liability. Where the liability relates to business expenses payable to the vendor which have previously been allowed as tax deductions by the target, then the forgiveness of such liability will be taxable to the target. Where the inter-company loan is capital in nature, the forgiveness should not result in the target being taxed.

c) Unwanted Assets

A balancing adjustment will arise if unwanted assets are being disposed of by the target group to unrelated parties. If the transfer value exceeds the tax written down value of the asset, the difference, known as a balancing charge, is taxable to the company. The balancing charge is restricted to the amount of allowances previously claimed. If the transfer value is less than the tax written down value of the asset, the shortfall, a balancing allowance, is deductible against the adjusted income of the company.

d) Distribution of Profits

If the Seller is a Malaysian company, the gain (notwithstanding capital in nature) made on the sale of shares can be distributed as dividend to the shareholders provided there is sufficient dividend franking credits which may be used to frank the payment of such dividend. Otherwise, the payer company would suffer additional tax cost to the extent of the shortfall of the franking credit. If the profits from the sale of shares are significant and the company does not have sufficient dividend franking credit, to distribute such profits, it may need to transfer its existing business, if any, to a separate entity and then liquidate the company. Proceeds paid to shareholders on liquidation are not subject to franking credit restrictions.

(ii) Buyer's Perspective

a) Acquisition Structure

It is common for the shares in the target company to be acquired through an investment holding company. An investment holding company provides the flexibility for additional future acquisitions. Moreover, as the investments held by an investment holding company are typically for long-term purposes, subsequent disposals of investments are normally not taxable unless the buyer is regarded as a share trader.

From a tax perspective, there is a disadvantage in using an investment holding company. An investment holding company is not regarded as carrying on a business, thus the deduction of expenses is limited. In addition, any excess of expenses over income for each year may not be carried forward as a tax loss. Thus, if an investment company is desired for other purposes (see below) it would be prudent to push most if not all the operating expenses to the subsidiaries. Alternatively, it is possible to use the investment holding company to provide management services to its subsidiaries and charge the subsidiaries management fees for services provided to these subsidiaries. However, care need to be taken as there may be service tax implications on management services provided.

b) Funding Cost

In any acquisition, one of the objectives would be to maximise the after-tax profits and thus the return on investment to the shareholders. For example, in a share deal, interest expense on the acquisition of shares is deductible to the extent that dividend income is received in the same year and should result in a tax refund to the shareholder company. For example:

	RM
Dividend (gross)	100
Interest expense, say	(90)
Net dividend	10
Net tax on dividend	2.8
Tax paid (imputation system)	(28.0)
Tax to be refunded	25.2

However, withholding tax would be applicable if the interest is paid to an overseas lender. The withholding tax can be avoided by interposing a Malaysian or Labuan bank as the lender. It is important to time the payment of interest with the flow of dividends to maximise the interest deduction and therefore maximise the tax refund. It should be noted that excess interest costs are not eligible for carry forward to offset against future dividend income.

c) Stamp Duty

In a share deal, the stamp duty rate is 0.3% of the consideration or market value (whichever is higher) and is payable by the buyer. Exemption from stamp duty is available, provided certain stipulated conditions are met.

d) Acquisition Expenses

Expenses incurred in relation to the acquisition (e.g. restructuring expenses, professional fees and transaction costs) are generally not tax deductible.

e) Debt/Equity Requirement

For Malaysian tax purposes, there are no thin capitalisation rules. Thus it would make sense to maximise the amount of debt used to acquire the shares of the target company. However, the Central Bank may impose restriction on the amount of local borrowings.

f) Preservation of Tax Losses

Unabsorbed tax losses, unutilised tax deprecation, tax incentives and dividend franking credits remain with the target company irrespective of the change of ownership in the target company.

g) Repatriation of Profits

The common methods of repatriation of profits are through payments of:

(a) Dividends
(b) Interest
(c) Royalties
(d) Management fees

The ability of a company to pay dividends to a shareholder (other than those paid out of exempt income) would depend on the availability of dividend franking credits.

Payment of interest, royalties, management and technical fees to non-residents would be subject to withholding tax, at rates which may be reduced by the relevant double tax treaty.

For certain industries, for example, the manufacturing sector, prior approval from the relevant licensing authorities would be required on the rate of royalty, management and technical fees payable to non-residents.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

a) Profits on Sale of Assets/Stocks

There is no other capital gains tax in Malaysia apart from the real property gains tax for the disposal of real property (land and building) and shares in real property company (i.e. company which has as its principal assets land and building).

Real property gains tax is levied at scale rates from 30% to 5% depending on the duration of ownership.

The gain on sale of trading stock would be subject to income tax as it is considered as part of the business income.

Any gain on the sale of fixed assets would not be subject to income tax but may give rise to balancing charge as explained above.

b) Indirect Tax and Stamp Duty

There is no indirect tax implication for the disposal of real properties (e.g. factory, office premises) and for the sale of machinery/equipment and trading stocks where import duty and/or sales tax have been paid.

If the seller has any facility for exemption from import duty and/or sales tax (including any facility for licensed manufacturers [licensed under the Sales Tax Act] in Malaysia) the following indirect tax implications would apply:

- The sale of exempt dutiable and/or taxable machinery/equipment (inclusive of spare parts) and raw materials would result in the import duty and/or sales tax becoming due and payable, unless the buyer is able to obtain exemption of import duty and/or sales tax for the purchase of the said machinery/equipment and raw materials from the relevant authorities.
- In respect of sales tax-free raw materials, taxable work-in-progress and taxable finished goods manufactured by the seller who is a licensed manufacturer under the Sales Tax Act, there are

provisions in the Sales Tax Act to allow the buyer to purchase these items free of sales tax subject to certain conditions being met. But basically the buyer has to be a licensed manufacturer as well. Otherwise sales tax would be due and payable upon sale by the seller.

Usually the cost of import duty and sales tax, if any, is borne by the buyer of the goods.

Insofar as stamp duty is concerned, the stamp duty cost is borne by the buyer for any transfers of real properties. Stamp duty ranging between 1% to 3% is payable on the market value of the assets.

(ii) Buyer's Perspective

a) Selection of Legal Entity as Acquisition Company

As in a share deal, the tax implications should be considered in conjunction with commercial objectives. The acquisition company may be an existing company of the Buyer or a new company depending on the tax position of the existing company. If the existing company is in a tax loss situation, it may be appropriate for the existing company to acquire the new business and for the profit earned by the new business to be set off against the tax loss of the existing company.

Where the new business is not expected to return profits or has a longer gestation period, it might be useful to consider injecting the new business into an existing profitable subsidiary. It would be preferable to select a subsidiary which has similar or complementary business as the new business.

The above arrangements however, must reflect commercial considerations to avoid any potential challenge from the tax authorities.

b) Equity Structure

Generally, acquisition of assets or interest in Malaysian incorporated companies of more than RM5.0 million in value or where there is acquisition of 15% or more of the voting rights in a Malaysian company by foreign interest would require the approval of the Foreign Investment Committee (FIC). FIC may impose foreign ownership restriction if it considers appropriate.

c) Funding Cost

Interest incurred on funds used to acquire a business under an asset deal should be fully tax deductible.

d) Cost Base Step-up

In the purchase of assets, it may be possible to step up the cost base of depreciable assets for the buyer. However, in allocating the purchase price to the assets, an independent professional valuation report should be obtained to support the reasonableness of the allocation of the purchase price to the various asset categories.

The step-up in cost base is not relevant if the transaction is between two related parties as the tax provisions would deem the transfer of fixed assets to be at their tax written down values.

e) Tax Treatment of Goodwill

No tax deduction is available for the amortisation of goodwill by the buyer. Therefore, the purchase price on an asset deal should, ideally, be allocated as much as possible to inventory, depreciable capital assets, and other items which are entitled to a tax deduction or tax depreciation. However, any gains derived by the seller on the sale of inventories and depreciable assets (to the extent of tax depreciation recouped) would be taxable in the hands of the seller.

f) Stamp Duty

Stamp duty ranging between 1% to 3% is borne by the buyer for the acquisition of the asset. Stamp duty exemption is available, provided certain stipulated conditions are met.

g) Indirect Tax

The issues are similar to that highlighted in the Seller's Perspective in an Asset Deal.

h) Preservation of Tax Losses and Unutilised Tax Depreciation

Unabsorbed tax losses, unutilised tax deprecation, tax incentives and dividend franking credits may not be transferred to the acquiring company.

In an effort to encourage mergers and consolidation within the financial services sector, the Ministry of Finance has agreed to provide tax credits on losses to anchor banks for merging with loss making banks under the Bank Merger Scheme.

i) Tax Incentives

Under an asset deal, if the vendor is entitled to any tax incentives or exemption, the purchaser may not be entitled to such incentives or exemptions and therefore a new concession or exemption should be sought.

j) Repatriation of Profits

The issues are similar to that highlighted in the Buyer's Perspective in a Share Deal.

EXIT ROUTE

There are generally three methods of exiting the investment, namely:

- Through a sale;
- Initial Public Offer (IPO); or
- Liquidation

In any of the three modes of exit, from the outset, it is important to consider the seller's commercial plans and tax status of the target company or assets acquired.

Where a sale or IPO is concerned, there should be no liability to income tax if the shares have been held as long-term investments and are non-RPC shares (see above). Similarly, distribution in specie upon liquidation of the Malaysian company will not be taxable on the shareholders unless these comprise real properties or shares in RPC companies, the gains from the disposal of which are subject to real property gains tax.

With effect from 2 May 2001, the 10% levy imposed on profits from portfolio investments that are repatriated within 12 months from the month the profits are realised, has been abolished.

ENDING REMARKS - PREPARATION FOR A DEAL

(i) Seller's Perspective

In preparing for a deal it would be expedient for the seller to identify the income tax and real property gains tax impact on any gains arising from the share or asset deal. Where possible, the tax costs should be quantified and the potential tax exposure minimised. Positive tax attributes and value of tax shelters, for example, the availability of carry forward tax losses, unutilised tax depreciation and availability of tax franking credits could also be factored in and used as a bargaining tool when negotiating with the buyer.

(ii) Buyer's Perspective

It is important for the buyer to carry out proper due diligence of the target company or asset to be acquired. This step will help in identifying the potential tax costs and where appropriate to explore means of minimising the impact or applying for exemption. The due diligence would also contribute towards managing the potential risks in future.

Consideration of the mode of acquisition, i.e. whether the acquisition should be in the form of a share or an asset deal, would depend on various factors including the tax attributes of the target company and business fit with the buyer. Buyers can also improve shareholder values and returns on investment through tax efficient structuring and planning.

NEW ZEALAND

Country M&A Team

Country Leader ~ Declan Mordaunt
Arun David
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SECTIONS

General Information
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GENERAL INFORMATION

(i) Introduction

The New Zealand tax system has undergone a series of major changes over the last decade driven by increasing globalisation, new, less restrictive company law legislation and an aggressive policy of deregulation. These factors have resulted in the government's desire to broaden the tax base. This was achieved by, among other things, introducing a flat rate consumption tax (good and services tax), complex international tax rules and specific regimes for group rationalisations.

A review of the New Zealand tax system has recently been conducted to determine whether it is adequate for today's needs. One of the suggestions from the review committee was for the government to reduce the New Zealand tax imposed on companies, to the extent that it is owned by non-resident investors. The idea behind this suggestion is to encourage foreign investment in New Zealand. No further announcements or draft legislation has been made to date.

New Zealand has a set of tax and company law rules governing mergers of companies, known as the Amalgamation Regime. When two or more companies amalgamate, from the date of amalgamation, one company nominated by shareholders succeeds to all rights and obligations of the others. The other companies are struck off the company register.

Wholly-owned groups of companies can be amalgamated using a simple short form procedure. Groups of companies not wholly owned must amalgamate under a more complicated procedure referred to as a long form amalgamation.

For tax purposes, the company succeeding on amalgamation is deemed to step into the shoes of the other companies and take over the tax obligations. In the case of a qualifying amalgamation, there is no transfer of assets or liabilities for tax purposes, as they are assumed to have been held throughout by the same party.

Amalgamation is an alternative to a share purchase or can be used as part of a subsequent restructuring.

Companies in a 100% group can elect to enter a tax consolidated group, which enables the group to be treated as one company for tax purposes. The primary advantages of tax consolidation are that assets transferred between group members are ignored for tax purposes and compliance requirements are simplified.

New Zealand has a general anti-avoidance provision, which allows the Inland Revenue to strike down arrangements that serve the purpose of tax avoidance. The provision is deliberately vague and has not until recently been actively used by Inland Revenue. Any structuring transaction aimed at achieving tax efficiency should be reviewed in the light of this provision.

(ii) Common Forms of Business Entity

The most common form of business entity used in New Zealand is the limited liability company. A company can be incorporated with relative ease at the Companies Office, which now offers an on-line service.

Another popular investment vehicle is the branch, which, unlike the company, is not a separate legal entity. If operated by a non-resident, the branch is treated as a non-resident for New Zealand tax purposes enabling profits to be repatriated free of withholding tax. The other benefit of a branch structure is the potential to utilise branch losses to offset foreign income. Like the company, a branch must file an income tax return in respect of its New Zealand-sourced income. When ascertaining the taxable income of the branch, head office costs can be allocated.

The branch and the company must both file annual audited financial statements with the Companies Office. In relation to the branch, the non-resident must also file its own financial statements.

Other popular investment vehicles include partnerships, trusts, unincorporated and incorporated joint ventures, and franchises. Partnerships and unincorporated joint ventures are not treated as separate entities for assessment purposes and tax is assessed by looking through to the participants. Trusts are often used as a tax planning tool.

(iii) Foreign Ownership Restrictions

Irrespective of which structure is utilised, a non-resident must obtain approval from the Overseas Investment Commission if the proposed investment exceeds NZ$50 million. For certain types of investments (particularly land), approval may be required for smaller investments. Approval is usually forthcoming as the process is generally considered a formality.

There are also certain infrastructure companies where foreign ownership is restricted, but these are rare.

(iv) Tax Rates

a) Corporate Tax

Income tax is levied at the rate of 33% on a resident company's world-wide income. There are no state or local income taxes.

Whilst New Zealand does not have a specific capital gains tax regime, capital gains on certain transactions are deemed to be income subject to income tax. For example, profits from the sale of real and personal property purchased with the purpose of resale are subject to income tax.

b) Withholding Tax

Interest, dividends and royalties paid to non-residents are subject to a New Zealand withholding tax. The rate of withholding varies depending on whether New Zealand has a DTA with the recipient jurisdiction.

In summary, the rates are usually as follows:

	Non - Treaty Country %	Treaty Country %
Interest	15	10-15
Royalties	15	10-15
Dividends	15-30	15-25

Although withholding tax is levied on dividends, the rate can effectively be rebated at no additional cost to the company if sufficient imputation credits are attached (see further below).

The rate of withholding tax imposed on interest is a minimum tax in the case of non-treaty and certain treaty countries. It can also be reduced to nil if interest is paid to a non-related party and the security is registered with the Inland Revenue. A 2% levy on the gross interest amount is payable instead.

There is no specific withholding tax on service fees. However, the definition of royalties is very wide and can include what might be regarded as service fees in other jurisdictions. In addition, New Zealand has a strict transfer pricing regime and service charges imposed must be at arm's length.

(v) Taxation of Dividends

The tax applying to dividends depends upon the level of imputation credits attached. Imputation credits are generated through the payment of tax to Inland Revenue and can be carried forward by companies from year to year provided that 66% continuity of shareholding is maintained.

Provided sufficient imputation credits are attached, dividends can effectively be paid without withholding taxes to both residents and non-residents. Under the foreign investor tax credit regime the withholding tax in certain instances can be rebated to the non-resident investor by payment of a supplementary dividend. The paying company can in turn claim, subject to certain restrictions, a tax credit for the cost of the supplementary dividends.

Where sufficient imputation credits are not attached, a non-rebateable withholding tax will apply when the dividend is paid. This withholding tax is in effect a payment on account of final income tax for the recipient.

(vi) Tax Losses

Losses can be carried forward by companies, branches, trusts and individuals provided there is at least 49% continuity of ownership from the time the losses are incurred to the time they are utilised. Losses are unable to be carried back.

Losses incurred by companies can also be used to offset income of other companies in the same group where there is at least 66% commonality of shareholding.

Following legislative changes, there is now limited scope to freshen losses before a shareholding change.

(vii) Thin Capitalisation

New Zealand resident companies and other business entities controlled by non-residents (50% or greater ownership interest) are subject to thin capitalisation rules. Under the rules, a deduction for interest is partially denied when the taxpayer's total interest-bearing debt/total asset ratio exceeds:

- 75% (the Government is considering reducing this ratio to 66%); and
- 110% of the worldwide group debt percentage

All interest-bearing debt is included in the calculation, not only debt with associated parties.

Notwithstanding the thin capitalisation rules, all costs incurred in the course of raising finance are normally deductible.

Debt instruments are also subject to a specific timing regime in New Zealand such that deductibility for taxation purposes is spread over the life of the instrument on a methodical basis. This is usually irrespective of when the payments are made.

Certain debt instruments with a very specific set of characteristics are treated as equity for taxation purposes.

(viii) Other Taxes

a) Goods and Services Tax (GST)

GST is a transaction based tax and is levied on the supply of goods and services in New Zealand. The main rate of GST is 12.5%, although GST is applied at 0% on some specific supplies (principally the transfer of a going-concern and supplies overseas). In addition, some supplies are exempt from GST, but these are relatively few.

b) Duties

There is no stamp duty payable on the transfer of real and personal property in New Zealand or capital duty on the issue of shares. Stamp duty was abolished on conveyances of real property from May 1999.

Whilst there are a number of other duties, the most significant one for present purposes is gift duty. Gift duty is levied progressively on most transactions that involve consideration at less than market value.

(ix) Other Matters

a) Tax Consolidation

Companies in a 100% group can elect to enter a tax consolidated group, which enables the group to be treated as one company for tax purposes. The primary advantages of tax consolidation are that assets transferred between group members are ignored for tax purposes and compliance requirements are simplified.

b) General Anti-avoidance

New Zealand has a general anti-avoidance provision, which allows the Inland Revenue to strike down arrangements that have a purpose of tax avoidance. The provision is deliberately vague and has not until recently been actively used by Inland Revenue. Any structuring transaction aimed at achieving tax efficiency should be reviewed in light of this provision.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profits on Sale of Shares

Profit on the sale of shares will not be subject to income tax provided the shares are held by the vendor as capital assets.

b) Distribution of Profits

If the vendor is a New Zealand company, the distribution of sale proceeds to shareholders as a dividend (even and in certain instances, on liquidation) will attract withholding tax unless imputation credits are attached. The sale itself will not generate imputation credits as it is usually a non-taxable capital gain.

Other methods of distribution are however usually possible which allow the shareholders to receive proceeds tax free if certain requirements are met. Although a share sale is beneficial for the vendor, it is usual for the purchaser to seek substantial warranties to limit potential liabilities.

(ii) Buyer's Perspective

a) Acquisition Structure

The use of a holding company to undertake an acquisition is often preferred in New Zealand due to the interest deduction rules.

b) Funding Cost

An acquisition will generally be financed with a mixture of debt and equity. A wide variety of equity investments are available in New Zealand and principally, these are limited by the constitution of the company involved.

Interest on the debt will be deductible where it can be established that it was incurred for the purpose of producing gross income or incurred in the course of carrying on a business. Interest is also automatically deductible where funds are borrowed to acquire shares in a subsidiary and, as a result, the use of holding companies in New Zealand is prevalent.

The thin capitalisation rules effectively create a gearing limitation (see comments regarding Thin Capitalisation under the section 'General Information'). Notwithstanding the thin capitalisation rules, all costs incurred in the course of raising finance are normally deductible.

Debt instruments are also subject to a specific timing regime in New Zealand such that deductibility for taxation purposes is spread over the life of the instrument on a methodical basis. This is usually irrespective of when the payments are made.

Certain debt instruments with a very specific set of characteristics are treated as equity for taxation purposes. Examples of such instruments are where debt has been issued in substitution for equity, or where the amount paid under the debt instrument is linked to the profit of the company.

c) Acquisition Expenses

In general, acquisition expenses adopt the same treatment as the assets purchased. For a share acquisition, therefore, the costs are a non-deductible capital item. By comparison, an asset acquisition allows for such expenses to be allocated to the assets purchased. Therefore, to the extent that those assets are depreciable, a tax deduction is available over time for the acquisition costs.

d) Debt/Equity Requirements

See comments regarding Thin Capitalisation under the section 'General Information'.

e) Preservation of Tax Losses

Where the target company has tax losses and imputation credits brought forward, these will be extinguished unless sufficient shareholder continuity is maintained (49% for losses and 66% for imputation credits).

Where a target has significant amount of tax losses and have appreciating assets, the buyer may consider an asset deal with cost base step-up.

f) Repatriation of Profits

Profits can be repatriated by the use of dividends, royalties, service fees and interest amongst others, but each of these is subject to various limitations in terms of withholding taxes and/or the transfer pricing regime as outlined previously.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

a) Profits on Sale of Assets/Stocks

The seller will usually want to attribute as much of the sale proceeds as possible to goodwill as the disposal of goodwill is not generally subject to income tax. Part of the balance is, however, likely to be subject to income tax. For example, a portion of depreciation previously claimed on an asset is reversed and, therefore, subject to tax if the sale proceeds exceed the asset's tax depreciated value. Proceeds in excess of original cost generally give rise to a non-taxable capital gain.

If the vendor is a company, goodwill can only be distributed free from income tax on liquidating the company (and then only to resident shareholders). Liquidation takes approximately eight weeks.

The sale of assets will not be subject to GST provided they are sold as part of a going concern.

b) Distribution of Profits

See comments regarding Seller's Perspective under the section 'Structuring a Share Deal'.

(ii) Buyer's Perspective

a) Acquisition Structure

Issues facing the buyer in relation to financing and repatriation are very similar to those for a share purchase.

For an asset deal, the buyer will usually want to attribute as much of the purchase price as possible to depreciable assets.

b) Funding Cost

See comments regarding Buyer's Perspective under the section 'Structuring a Share Deal'.

c) Cost Base Step-Up

The buyer is able to 'step up' the value of depreciable assets to maximise depreciation claims, provided this can be supported by a valuation and the seller is not an associated party.

d) Treatment of Goodwill

Goodwill on a purchase is not deductible for tax purposes. Certain specific types of intangible property may, however, be depreciated. To be depreciable, such property must have a 'fixed legal life' and therefore usually involves the right to use something for a fixed period. Examples of such depreciable property include the right to use a copyright, patent or trademark.

e) Other Matters

Specific anti-avoidance provisions: There are a number of specific anti-avoidance provisions that address share dealing transactions and cost allocations. The share dealing provisions are designed to counter dividend stripping and loss utilisation arrangements, while the cost allocation provisions give Inland Revenue the power to determine the cost of some assets transferred on sale.

EXIT ROUTE

As capital gains are not taxable in New Zealand, the most common exit strategy is a sale of shares. Irrespective of whether assets or shares are sold, there is often cash to distribute overseas following a sale (unless shares are sold in the top tier company). The priority is then to minimise withholding tax on repatriation of these funds.

(i) Pay a fully imputed dividend, which will not be subject to withholding tax
If shares are being sold, paying out a dividend before sale will enable imputation credits to be used before they are forfeited.

(ii) Migrate the company
New Zealand's company law legislation provides for migrations whereby a company is removed from New Zealand's register and placed on an overseas register. Funds can then be accessed overseas and as there is no distribution in New Zealand, there is no withholding tax. The ability to migrate will depend on whether the foreign jurisdiction's corporate law provides for migration. Anti-avoidance provisions will also need consideration.

The repayment of debt from an overseas associate is not subject to withholding tax and, therefore, also allows for a simple method of repatriation.

ENDING REMARKS - PREPARATION FOR A DEAL

The New Zealand tax legislation and investment climate provide opportunities to structure an investment and exit tax efficiently. Careful planning is, however, needed to ensure that pitfalls are avoided.

PHILIPPINES

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GENERAL INFORMATION

(i) Introduction

Philippines imposes income tax on income derived in the Philippines, and on income which is derived outside the Philippines, but received in the Philippines.

Capital gain is subject to different tax rates depending on the nature of the underlying transactions.

Various incentives are available for industries and activities encouraged by the Philippine government. These include:

- Board of Investment registered enterprises;
- Philippine Economic Zone Authority registered enterprises;
- Subic Bay Freeport registered enterprises;
- Regional headquarters; and
- Regional operating headquarters.

Entities carrying on approved activities may take advantage of a reduced/preferential tax rates or full exemption from income tax and certain taxes for a specified period (generally between 4 and 8 years depending on the nature of tax incentives).

(ii) Most Common Forms of Business Entity

The most common forms of business entity in the Philippines are locally incorporated companies or branches of overseas companies. Other forms of business such as partnerships (generally for professionals), and joint ventures are also available.

(iii) Foreign Ownership Restrictions

Generally, there are no restrictions on foreign investments in the Philippines except for certain industries – for example, a maximum of 40% foreign equity is allowed for ownership of private land and operation of public utilities.

(iv) Tax Rates

a) Corporate Tax

The normal corporate income tax rate is 32% based on net income. However, corporations are subject to minimum corporate income tax (MCIT) of 2% of the gross income, if it is higher than the normal corporate income tax. MCIT is imposed on a corporation from the fourth taxable year following the year in which such corporation commenced its business operations.

b) Branch profits tax

Profits of a Philippine branch are subject to normal income tax rate of 32% and MCIT of 2%, whichever is higher. Any profit remitted by a branch to its head office is generally subject to 15% branch profit remittance tax (BRPT) unless reduced by a tax treaty. Profits from those activities which are registered with Philippine Economic Zone Authority are not subject to branch profit remittance tax.

c) Withholding Tax

On payments to non-residents

Dividends, interest, royalties and other technology transfer related services, management and other service fees paid to non-residents of the Philippines may be subject to withholding tax. The rates are as follows:

	Non Treaty Rate %	Treaty Rate %
Interest	20	10-15
Dividends	15-32	10-25
Royalties (technology transfer related services)	32	7.5-25
Service and management fees	32	Exempt if no PE

Philippines has a comprehensive network of double tax agreements which operate to reduce withholding tax and exempt business profits derived by a company resident in a treaty country, which does not have a permanent establishment (PE) in the Philippines.

On payments to domestic companies

Interest payments made by a domestic company to another domestic company are not subject to withholding tax. However, interest on borrowings obtained from an expanded foreign currency deposit system of a domestic bank or offshore banking unit is subject to 10% final withholding tax. Interest paid on funds sourced from the public is subject to final withholding tax of 20%. Further, payments for royalties and services involving technology transfer to domestic companies are subject to 20% final withholding tax.

Certain domestic payments are subject to expanded withholding taxes (EWT). EWT withheld is creditable against income tax due by a recipient of the relevant income. The following are some of the payments which are subject to EWT and the applicable EWT rates:

Nature of payments	Applicable EWT rates (%)
Professional and talent fees for services paid • by domestic corporations • by resident individuals	 10 20
Rentals for the use of real property	5
Customs, insurance, real estate and commercial brokers and agents of professional entertainers	10
Certain contractors	2
Certain payments by credit card companies	1

(v) Taxation of Dividends

Dividends paid to a resident corporation are not subject to tax. Dividend payments made to non-resident foreign corporations are generally subject to 32% Philippine income/withholding tax. However, the tax rate may be reduced to 15% if the country where the recipient is domiciled allows a credit against the tax due from the said recipient company, taxes paid or deemed to have been paid in the Philippines or if such country of the recipient does not impose any tax on such dividends.

If the foreign company investor is located in a country which has a tax treaty with the Philippines and such treaty provides for a lower rate of withholding tax, the lower rate will apply.

(vi) Net Operating Loss Carry-Over

Net operating losses may be carried forward by a domestic company for a period of three consecutive years immediately following the year of such loss. However, net loss carry-over shall not be allowed if there has been a substantial change (i.e. more than 25%) in the ownership of the company.

(vii)Thin Capitalisation

There are no thin capitalisation rules in the Philippines.

The decision to set a debt to equity ratio is generally governed by commercial considerations or by other government agencies (i.e. the Board of Investments in order for the Board to monitor if the company meets the requirements for the incentives granted). However, where a company is set up to take advantage of a tax concession or requires a special licence from the government (e.g. banking and insurance), the regulatory body may require certain ratio to be complied with.

(viii) Other Major Taxes

a) Value Added Tax (VAT)

Generally, 10% or 0% VAT is imposed on sale of goods and services. Services rendered in the Philippines are subject to 10% VAT. The 0% VAT may apply provided certain conditions are complied with.

b) Documentary Stamp Taxes (DST)

The Philippines also imposes DST on certain documents including:

- Issuance and transfer of shares, at the rates of 1% and 0.75% respectively based on the par value of the shares.
- Loan agreements/documents at the rate of 0.15% based on the face value of the agreement or availment of the debt.
- Transfer of real estate at the rate of 1.50% based on the selling price or the market value, whichever is higher.

c) Fringe Benefit Tax (FBT)

FBT at the rate of 32% is imposed on the grossed-up monetary value of fringe benefits furnished or granted to the employee (except for rank and file employees) unless the fringe benefit is required by the nature of the trade, business or profession of the employer, or when the fringe benefit is for the convenience or advantage of the employer. The value of the fringe benefit granted is divided by 68% to arrive at the grossed up amount.

The term 'fringe benefit' is defined to mean any goods, services or other benefits furnished or granted in cash or in kind by any employer to an individual non-rank and file employee.

d) Local Business Tax (LBT)

LBT at the rate not exceeding 0.75% is imposed on the gross receipts of the preceding calendar year is payable to the local government unit(s) where its principal and/or branch office(s) is/are located. However, LBT is not imposed on an enterprise which has been granted certain tax incentives provided certain conditions are met.

e) Real Property Tax (RPT)

RPT at the rate not exceeding 2% is imposed on the assessed value of the real properties and fixed machineries and equipment of a domestic company. An additional 1% of the assessed value of the real property may be collected for the Special Education Fund which shall be in addition to the basic RPT. RPT is not imposed on an enterprise which has been granted certain tax incentives provided certain conditions are met.

f) Transfer Tax

Transfer tax of 0.5% is imposed on the selling price or the fair market value of the real property transferred.

g) Capital Gain

Generally, gains from sale of shares of stock (not traded in the stock exchange) are subject to capital gains tax of 10% (5% for the first P100,000) unless exempted under a tax treaty. Sale of shares listed and traded through the local stock exchange are also subject to stock transaction tax of 0.5% based on the gross selling price, which is paid by the seller or transferor.

Generally, gains on sale of real and personal property are subject to the normal income tax if real property is used in trade or business. However, gains on sale of real properties which are treated as capital assets are subject to 6% final tax based on the gross selling price or fair market value, whichever is higher.

(ix) Concessions Relating to Mergers and Acquisitions

For income tax purposes, no gain or loss shall be recognised if such gain or loss occurs in pursuance of a plan of merger or consolidation, such as:

(a) a corporation, which is a party to a merger or consolidation, exchanges property solely for stock in a corporation, which is a party to the merger or consolidation;

(b) a shareholder exchanges stock in a corporation, which is a party to the merger or consolidation, solely for the stock of another corporation which is also a party to the merger or consolidation;

(c) a security holder of a corporation, which is a party to the merger or consolidation, exchanges his securities in such corporation, solely for stock or securities in another corporation, which is also a party to the merger or consolidation.

Likewise, the transfer of property (assets or shares) may be done through a tax-free exchange. To qualify for a tax free-exchange, property must be exchanged for shares of stock of the transferee entity and as a result of such exchange, the transferor would gain control of the transferee entity. However, a ruling from the Philippine tax authorities is required to confirm the tax-exempt status of the transaction.

In addition, transfers of properties, which qualify for a tax-free exchange and merger, are not subject to value-added tax.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profit on Sale of Share

Generally, gains on sale of shares (not traded in the stock exchange) are subject to capital gains tax of 10% (5% for the first P100,000). Likewise, sale of shares traded in the stock exchange is subject to stock transaction tax of 0.5% based on the selling price. However, the sale may be exempted from capital gains tax and stock transaction tax under a tax treaty.

b) Documentary Stamp Tax

Transfer/sale of shares is subject to DST of 0.75% based on the par value of the shares.

c) Shareholders loan

Loans by a shareholder to its subsidiary in the Philippines which are condoned/forgiven shall be considered as income to the subsidiary, subject either to income or donor's tax depending on the intention of the parties.

However, loans condoned and converted into paid in surplus shall not be subject to income or donor's tax as such conversion is not regarded as income but as additional capital contribution.

On the other hand, a change of creditor as a result of the transfer/sale of loan to the acquirer is generally subject to DST applicable to new loans unless there is no subrogation involved.

d) Unwanted assets

Transfer/sale of the unwanted assets out of the target group is subject to the following taxes:

- corporate income tax of 32% on the gain or MCIT of 2%, whichever is higher;
- VAT of 10% for inventories sold;
- DST of 1.5% for real property transferred; and
- Transfer tax of 0.5% for real property transferred.

(ii) Buyer's Perspective

a) Acquisition Structure

Whether a deal is structured as a share deal or asset deal may largely depend on commercial and tax considerations.

In acquiring a target in the Philippines, a tax efficient structure may maximise the after-tax profits and thus the return on investment. For example, while a share deal may result in lower taxes, the buyer may not get a step-up in the cost basis of the assets of the company acquired. An after-acquisition reorganisation may achieve a step-up in cost basis although the tax implication of such reorganisation should be considered.

Setting up Holdco in the Philippines may no longer be tax efficient due to the imposition of the 10% improperly accumulated earnings tax on unreasonable amount of retained profits. To avoid this tax, retention due to reasonable business needs must be proven. But retention of profits in a holding company is prima facie evidence of unreasonable profit retention. Hence, a holding company within the Philippines may no longer be a tax efficient structure to park dividends.

To minimise the Philippines tax on gains derived from any subsequent disposal of an investment in the Philippines, depending on the tax regime of the investor's home jurisdiction, if the holding company of the Philippines target is located in countries such as the Netherlands and Singapore, any gains derived from the sale of the shares of the Philippines target should not be subject to Philippines tax. However, in respect of gains derived by the Singapore investors, the exemption would apply provided that the target's major assets do not consist of immovable properties.

b) Funding Structure and Debt/Equity Ratio

There is no specific debt to equity ratio prescribed for tax purposes. Deductibility of interest is largely dependent on whether the transactions between the related parties are considered arm's length.

In practice, a debt to equity ratio of 3:1 is often used as safe haven as this is also the ratio required for entities registered with the Board of Investments as a condition for the availment of incentives.

c) Tax Treatment for Acquisition Expense

Acquisition costs which include, among others, professional fees and taxes passed on to the buyer, are not deductible for income tax purposes. The same should be capitalised or should form part of the cost of the investment.

The said expenses, however, shall be allowed as deduction for purposes of calculating the capital gains tax which is applicable in case of subsequent disposal of the shares.

Thus, it is important to book such expenses in a country where an appropriate tax deduction may be allowed.

d) Preservation of Tax Losses and Tax Incentives

Where a target company has accumulated losses carried forward and the buyer wishes to preserve the losses, it will have to acquire the business through a share deal, as there are no provisions to transfer losses from one entity to another.

However, net losses will not be allowed to be carried over if there has been a substantial change (i.e. more than 25%) in the ownership of the business.

If a target company has been granted tax incentives, the buyer will have to acquire the shares of the company if it wishes to preserve the incentives. However, approval from the relevant government body must be obtained.

e) Repatriation of Profits

See Taxation of Dividends in the section, 'General Introduction'.

In addition, dividends may only be declared out of the company's unrestricted retained earnings. Equity in net earnings in subsidiaries may not be declared as dividends unless received as dividends.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

a) Profit on Sale of Share

Gains from sale of the assets would form part of the taxable income of the seller and are subject to the normal corporate income tax of 32% or the minimum corporate income tax of 2% based on gross income, whichever is higher, instead of capital gains tax. The gains are the difference between the selling price and the costs of the assets.

It is advantageous to a corporate seller to enter into an asset deal if it has tax losses to offset against the gain from the sale. Alternatively, an asset sale may be preferred if the sales price of the inventories and tax depreciable assets is not substantially higher than their book value.

b) Transfer Duties/Tax

Transfer tax of 0.5% is imposed on the selling price or the fair market value of the real property transferred.

c) VAT and Other Taxes

Sale of assets is subject to 10% VAT (which may be passed on to the buyer) and 0.75% local business tax based on the gross selling price. Documentary stamp tax may also be imposed if the sale involves an assignment of receivables and real properties. Transfer of real property is subject to 0.5% transfer tax based on the selling price or the fair market value, whichever is higher.

d) Distribution of Sales Proceeds

On distribution, the corporate property and assets must be appropriated to payment to corporate debts and liabilities before any distribution among stockholders can be made. Debts secured by liens are entitled to some preferences, so are claims given a priority by stature. Stockholders are entitled to participate in the assets, after the payment of the creditors, in proportion to the number of shares held by each, unless the articles of incorporation regulate the distribution of corporate stock among stockholders.

e) Bulk Sales Law (BSL)

Sales of assets may be covered by the BSL. The primary objective of BSL is to compel the seller to execute and deliver a verified list of his creditors to his buyer, and notice of intended sale to be sent in advance to said creditors. Non-compliance with the requirements under the law would not only render certain transactions void, but would also subject the violators to criminal liabilities.

Moreover, the sworn statement of listing of creditors must be registered with the Department of Trade and Industry.

(ii) Buyer's Perspective

a) Acquisition Structure

An asset deal allows a purchaser to select the desirable assets to be acquired and to transfer assets between one or various entities (including offshore entities) so as to optimise future intra-group payments.

However, in transferring the business, care should be taken to ensure that the income tax (on the gain), value-added tax and local business tax (based on gross selling price), documentary stamp tax and transfer tax (particularly with respect to the transfer of property) are minimised.

b) Funding Structure Cost and Debt/Equity Ratio

Interest incurred on funds used to acquire a business under an asset deal is tax deductible.

c) Cost Base Step-Up

An asset deal often allows the buyer to step up the cost basis of acquired assets for tax purposes. This enables tax deductions to be maximised through depreciation or amortisation and/or additional interest costs if the acquisition is funded by debt.

Where real estate is involved, the documentary stamp tax, transfer tax, and local business tax on the transfer may be significant and thus, in structuring the deal, such taxes should be minimised where possible.

d) Treatment of Goodwill

Amortisation of goodwill is not deductible. However, certain business rights may be amortised for tax purposes.

e) Transfer duties/tax

Transfer tax of 0.5% is imposed on the selling price or the fair market value of the real property transferred.

f) Repatriation of profits

Under an asset deal, where all or a substantial part of the business is being sold off, the shareholder may consider liquidating the company. Liquidating dividends are subject to capital gains tax.

g) VAT Refund

Application for refund or credit certificates must be filed with the BIR of the Department of Finance not later than 2 years from the close of the quarter when the related zero-rated sales/capital purchases were made.

EXIT ROUTE

There are various ways whereby a buyer may harvest its fruits of acquisition:

a) *Profit Repatriation*

There may be avenues whereby the profits of the target company may be repatriated to the home country other than through dividends. These include the payment of licence fees, royalties, interest and management fees. Such payments are generally subject to Philippine income/withholding taxes as follows:

	Tax Rate (%)
Management fees	32
Interest	20
Royalties	32
Technical assistance/service fees	32

However, appropriate tax treaties may reduce the applicable Philippine income/withholding tax rates or even exempt the same from Philippine tax. For example, interest payments to a Netherlands entity may be subject to 10% Philippine income/withholding provided certain conditions are met.

Management fees in consideration for services rendered outside the Philippines that are recharged at costs should not be subject to withholding tax or should not be taxed if an appropriate double tax agreement exists that exempt the fee from tax due to the non-existence of a permanent establishment in the Philippines.

Philippine tax legislation does not contain specific anti-treaty shopping provisions and where an arrangement (with commercial substance) takes advantage of a tax treaty, the reduced rate provided under that treaty should generally prevail.

b) *Return of Investment*

Return on investment may be made by way of disposal/sale of investment. However, profits on the sale of shares or assets shall be subject to applicable tax.

In this event, it would be appropriate to structure the acquisition such that the profit is located in a tax haven country or other appropriate location to minimise tax on such profits. For example, gain from the sale or the transfer of Philippine company shares by a resident of Netherlands shall be exempt from capital gains tax regardless of whether the assets of the Philippine company consist primarily of immovables.

c) *Initial Public Offering (IPO)*

Another exit route may be through an IPO. The acquisition vehicle/acquired company may be listed in the Philippine Stock Exchange provided certain requirements are complied with.

Sale of shares through initial public offering is taxed at the rates specified below based on the gross selling price or gross value of the shares sold in accordance with the proportion of shares sold to total outstanding shares of stock after the listing in the local stock exchange:

	Tax Rate (%)
Up to 25%	4
Over 25% but not over 33 1/3%	2
Over 33 1/3%	1

ENDING REMARKS - PREPARATION FOR A DEAL

(i) Seller's Perspective

A seller may structure its deal in a less tax burdensome manner so as to maximise its profits. This aim may generally be achieved through a share deal.

However, where a buyer does not accept a share deal due to commercial reasons such as existence of contingent liabilities, the seller may be required to enter into an asset deal. There are also opportunities to minimise the costs under an asset deal for the seller.

(ii) Buyer's Perspective

Buyers are encouraged to carry out proper due diligence of the targets to minimise risks. In addition, if an asset deal is involved, the costs involved in transferring the business assets may be significant and should therefore be managed properly.

To maximise the return, the buyer would need to ensure that the costs of the deal and future tax costs such as withholding tax on repatriation of profits and capital gains tax on subsequent sale of assets or shares are minimised. Advance planning should help a buyer to achieve such aims.

SINGAPORE

Country M&A Team

Country Leader ~ David Toh
David Sandison

SECTIONS

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GENERAL INFORMATION

(i) Introduction

Singapore imposes income tax on income derived in Singapore and on income which is derived outside Singapore but received in Singapore. Received in Singapore means income that is

- remitted to, transmitted or brought into Singapore;
- applied in or towards satisfaction of any debt incurred in respect of a trade or business carried on in Singapore; and
- applied to purchase any movable property, which is brought into Singapore.

Capital gains are generally not subject to tax. From 13 October 2001, short term capital gains arising on disposition of real estate or shares of private companies whose assets consist substantially of real estate within 3 years of purchase, would no longer be taxable. However, gains from disposal made by property traders and property developers continue to be subject to income tax as ordinary business profits.

A number of incentives are available for industries and activities encouraged by the Singapore government. These include:

- Pioneer enterprise
- Export enterprise
- Operational headquarters
- Business headquarters
- Finance and treasury centre
- Approved fund managers
- Approved international shipping enterprise
- Global trader programme
- Venture capital companies

Entities carrying on approved activities may take advantage of a reduced concessionary tax rate (generally 10%) or full exemption from income tax for a specified period (generally between 5 to 10 years depending on the nature of tax incentives).

(ii) Common Forms of Business Entity

The most common forms of business entity in Singapore are locally incorporated companies or branches of overseas companies. Other forms of business such as partnership (generally for professionals), trust and joint venture are also available.

(iii) Foreign Ownership Restrictions

There are generally no restriction on foreign investments in Singapore except for industries such as banking and telecommunication.

(iv) Tax Rates

Corporate Tax

The general income tax rate for resident and non-resident corporations (i.e. branches of foreign companies) is 24.5%. However from the year of assessment 2002, three-quarters of the first S$10,000 of chargeable income (i.e. the amount on which tax is imposed) and half of the next S$90,000 of chargeable income is exempt from tax. Thus, for the first S$100,000 of chargeable income, S$52,500 is exempt from tax. The remaining portion of the chargeable income is subject to tax at the rate of 24.5%. Dividends received from Singapore companies would not be taken into account while computing the exemption. In addition, a one-off rebate of 5% on the total tax liability is available for the year of assessment 2002.

Withholding Tax

Interest, loan fees, royalties, management fees and technical assistance fees paid to non-residents of Singapore may be subject to withholding tax.

	Non-Treaty Rate %	Treaty Rate %
Interest, loan fees, royalties, leases	15	0 - 15
Management fees and technical fees	24.5	0 - 24.5

Where the services relating to the derivation of certain payments that normally attract withholding tax, such as loan fees and technical service fees are performed entirely outside Singapore and the payments are at an arm's length, such payments are not subject to withholding tax. Management fees paid to related entities, which are charged at cost by the recipient, are also not subject to withholding tax.

In addition, payments of interest, royalties and licensing fees may also be exempt from tax under a relevant tax concession granted to a payer or under incentives granted to financial industries.

Singapore has a comprehensive network of double tax agreements which operate to reduce withholding tax and exempt business profits derived by a company resident in a treaty country, which does not have a permanent establishment in Singapore.

Where the non-resident entity conducts operations in Singapore, inter alia, through a Permanent Establishment (for instance a branch), it may obtain a waiver (subject to the satisfaction of certain conditions) from withholding tax and its income would be subject to tax under the same procedure as that applicable to a resident.

(v) Taxation of Dividends

To avoid double taxation at the corporate and shareholder levels, Singapore adopts an imputation system for the taxation of dividends. Income tax paid by a Singapore resident company is imputed to the dividends paid to its shareholders such that the shareholders are deemed to have paid the tax equivalent to the underlying tax paid by the company.

Dividends paid out of income that is entitled to a tax concession (i.e. exempt from tax or subject to a concessionary rate of 10%) and dividends received from overseas that is not subject to tax in Singapore due to the availability of foreign tax credits may be distributed as dividends to shareholders tax free. Any subsequent distribution of dividends by the shareholder may also be free of tax depending on the nature of the underlying income, the percentage of ownership in the payer company, and number of tiers of companies through which the dividends are being paid.

Dividends not paid out of any of the above income (such as capital profits) are taxable to the corporation declaring the dividend at the prevailing corporate tax rate (referred to as Section 44 charge). However, such tax will be treated as tax paid in advance and may be used to set off against the corporation's future tax liabilities.

Corporations that repurchase their shares (to the maximum of 10% of its share capital) are considered to have paid a dividend out of distributable profits and hence must ensure sufficient franking credits exist to frank the dividends paid. Where there are insufficient franking credits, the corporation must pay the shortfall to the Comptroller and the shortfall would be treated as tax paid in advance. Payment out of a share capital reduction exercise is not regarded as a payment of dividends provided it is paid out of paid-up capital or share premium reserve and not out of capitalised profits.

(vi) Losses Carry-Forwards and Unabsorbed Capital Allowance

Operating losses may be carried forward indefinitely and applied against income in future years. A corporation may utilise a loss as long as its shareholders on the last day of the year in which the loss was incurred are substantially the same as the shareholders on the first day of the year of assessment in which the loss is to be utilised. The shareholders are considered to be substantially the same if 50% or more of the shareholders at the two points in time are the same.

Unused capital allowances may also be carried forward indefinitely where the corporation carries on the same business and the shareholders on the last day of the year in which the allowances arose are substantially the same as the shareholders on the first day of the year of assessment in which the unused allowances would be used.

A waiver to comply with the above ownership requirements may be obtained from the Minister for Finance where the substantial change in shareholdings is not for the purpose of deriving a tax benefit. Losses which would otherwise be forfeited may then be utilised but generally only against income from the same business in respect of which the losses were incurred.

(vii) Thin Capitalisation

There are no thin capitalization rules in Singapore. The decision to set a debt to equity ratio is generally governed by commercial considerations. However, where a company is set up to take advantage of a tax concession or requires a special licence from the government (e.g. banking, insurance, telecommunications), the regulatory body may require certain ratios to be complied with.

(viii) Other Taxes

The Goods and Services Tax (GST) rate is 3%. However, certain goods or services such as transfer of shares are exempt from GST. A transfer of business which satisfies certain conditions is also exempt from GST (see paragraph (ix) below, 'Concessions Relating to Mergers and Acqusitions').

Singapore imposes stamp duty on documents relating to the transfer of shares (at a rate of 0.2%) and transfers of real estate (at ad valorem rates of up to 3%). However, for instruments executed between 13 October 2001 and 31 December 2002, the stamp duty is reduced to 0.14% for share transfer and 2.1 % for transfer of real estate.

(ix) Concessions Relating to Mergers and Acquisitions

The Income Tax Act, GST Act and Stamp Duty Act provide some concessions when a company is being reorganised.

For income tax purposes, in respect of sales of tax-depreciable assets to a related party, the transferor and transferee may elect to transfer these assets at the tax written down value without giving rise to the tax depreciation previously allowed being recharged to the transferor. Parties are related where the buyer controls the seller or vice versa or where they belong to the same group of companies.

For GST purposes, a transfer of a business as a going concern would not be regarded as a taxable supply and would therefore not be subject to GST. In order for a transfer to qualify as a transfer of a going concern, inter alia, the assets must be used by the transferee to carry on the same kind of business as that of the transferor. Where only part of a business is transferred, that part must be capable of separate operation in the same kind of business in order for the transfer to meet the going concern requirement.

Corporate reconstructions and amalgamations may be exempt from stamp duty (on the transfer of shares or real estate as stamp duty is not applicable on the transfer of other assets) if the following conditions are met:

- *The transfers are in connection with a scheme for the reconstruction of companies.*
- *A transferee company has been incorporated or has increased its capital with a view to the acquisition of the undertaking or not less than 90% of the issued share capital of the transferor company.*
- *At least 90% of the consideration for the acquisition consists of shares of the transferee company.*

From 1 July 2000, stamp duty relief is extended to transfer of assets to a Singapore company from an associated company notwithstanding that less than 90% of the acquisition consideration consists of the shares of the acquirer company. Further, where shares are to be acquired, relief will be available notwithstanding that the share acquisition is for less than 90% of the target company's shares.

Stamp duty concession may apply in respect of any restructuring for the purposes of seeking an initial public offer.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

Profit on Sale of Share

For a seller, it would be in its interest to maximise the after-tax profits on the sale of its business. Generally, unless the vendor is a share dealer or venture capitalist, the profits derived from the sale of shares should not be subject to tax as such profits should be of a capital nature.

Distribution of Profits

As indicated in paragraph (v) above ('Taxation of Dividends'), capital profits which have not been subject to tax may not be distributed as effectively tax-free dividends unless the vendor company has sufficient franking credit (e.g. where the company's accounting profits had been set off by subsequent operating losses but has accumulated franking credit due to tax paid on earlier profits). In order to distribute such capital gains to shareholders on a tax-free basis, the company may be liquidated (after transferring all its assets or business out of the company). Distribution of liquidation proceeds is not subject to the franking credit requirements.

(ii) Buyer's Perspective

Whether a deal is structured as a share deal or asset deal may largely depend on commercial considerations. A share deal may, however, be subsequently restructured as an asset deal to allow it to be completed on a more tax-efficient basis.

Generally, it is less expensive for a purchaser to acquire the business under a share deal as the stamp duty on the transfer of shares is currently 0.14% of the consideration whereas asset deals involving real property is subject to a current maximum duty of 2.1% of the property's value.

Preservation of Tax Losses and Tax Concessions

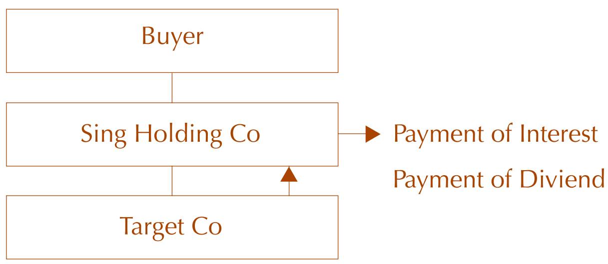
Where a target company has accumulated losses carried forward and the buyer wishes to preserve the losses, it will have to acquire the business via a share deal as there are no provisions to transfer losses from one entity to another. The rules requiring continuity of shareholdings in order to utilise the losses would apply. However, if the available losses do not affect the price, the waiver should generally be granted.

If a target company has been granted a tax concession, the buyer will have to acquire the shares of the company if it wishes to preserve the concession and seek prior approval from the relevant government body to continue to benefit from the concession.

Acquisition Structure

In acquiring a target in Singapore, a tax-efficient structure may maximise the after-tax profits and thus the return on investment. For example, in a share deal, interest expense on the acquisition of shares is deductible to the extent of the dividend income received in the same Year of Assessment and should result in a tax refund to the shareholder company (see Example 1).

Example 1



In the structure outlined in Example 1, the holding company would be able to obtain a tax deduction for interest expense paid and thus should obtain a tax refund as follows:

	$
Dividend	100
Interest expense, say	90
Net dividend	10

	$
Tax on net dividend	2.45
Tax paid (imputation system)	24.50
Tax to be refunded	22.05

However, if the interest is paid to an overseas lender, interest withholding tax may apply. In addition, the timing of the payment of the dividend may not coincide with the payment of interest. Therefore, the loan should be structured in such a way as to take into account the timing of the flow of dividends to maximise the interest deduction and therefore the tax refund. It should be noted that excess interest costs are not eligible for carry-forward to offset against future dividend income.

Singapore has a wide network of double tax agreements and a favourable regime relating to foreign dividends (i.e. generally tax-free where there are sufficient foreign tax credits). Therefore, the use of a Singapore company as the acquiring company for targets both inside and outside Singapore should maximise the group's after-tax profits.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

Profits on Sale of Assets

In an asset deal, any price charged for goodwill should not be subject to tax in the hands of the seller. However, any profits on the sale of inventories or tax depreciable assets (i.e. tax depreciation recouped) should be subject to tax in the hands of the seller.

A corporate seller should be prepared to enter into an asset deal, if it has tax losses or unutilised tax depreciation, or alternatively, if the sales price of the inventories and tax depreciable assets is not substantially higher than their book value.

In allocating the price for the assets sold, the value allocated to inventories and tax depreciable assets should be on an arm's length basis, otherwise it may be challenged by the tax authorities.

Distribution of Profits

As indicated above, if the company does not have sufficient franking credit, it may not be able to distribute the capital gain as effectively tax-free dividends. Under an asset deal, where all or a substantial part of the business is being sold off, the shareholder may consider liquidating the company as liquidation proceeds received by the shareholder should not be taxable to the shareholder and are not subject to the franking credit requirements.

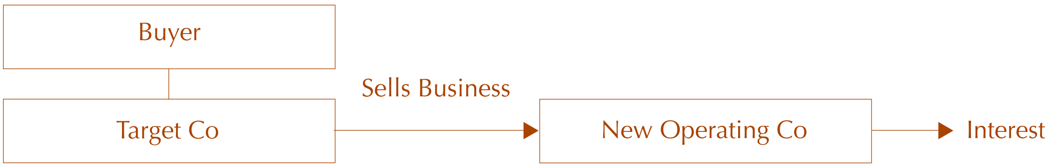
(ii) Buyer's Perspective

Acquisition Structure

An asset deal allows a purchaser to select the desirable assets to be acquired and to transfer assets between one or various entities (including offshore entities) so as to optimise future intra-group payments.

Where a vendor insists on a share deal, the purchaser may restructure the target after acquisition by selling the business to a subsidiary to maximise the step-up base of certain assets and to maximise the deductibility of interest costs (see Example 2).

Example 2



If, after the transfer of the business from Target to New Operating Co, Target has no substantial operations, it may be liquidated with the resulting distribution made tax-free in Singapore. If Target has surplus cash, this method may enable the vendor to effectively withdraw the surplus cash and thus reduce its cost of acquisition.

However, in transferring the business, care should be taken to ensure that stamp duty (particularly with respect to the transfer of property) and income tax (with respect to depreciable assets and trading stock) are minimised.

Funding Cost

Interest incurred on funds used to acquire a business under an asset deal should be tax deductible. Since Singapore does not have a debt to equity ratio requirement for tax purposes, it is possible to maximise the amount of debt used to acquire a business.

Where, however, the business acquired consists of assets, which may not produce regular returns (e.g. investment in a subsidiary), interest would not be tax deductible if no income is derived from such assets in a particular year. Thus, in an asset deal, the assets may be acquired by separate entities and the debt/equity may be appropriately structured to maximise the interest deduction.

Cost Base Step-Up

No tax deduction is available for the amortisation of goodwill. Therefore, the purchase price on an asset deal should, if appropriate, be allocated as much as possible to inventory, depreciable capital assets, and other items that will generate a tax deduction.

In allocating the purchase price to assets, a formal valuation report should be obtained to support the reasonableness of the allocation of the purchase price to various assets.

An asset deal often allows the buyer to step up the cost basis of acquired assets for tax purposes. This enables tax deductions to be maximised through depreciation or amortisation and/or additional interest costs if the acquisition is funded by debt. Where real estate is involved, the stamp duty on the transfer may be significant and thus, in structuring the deal, such duty should be minimised where possible.

However, obtaining a step-up in the cost basis by the buyer may have negative tax implications to the vendor, which need to be managed.

Acquisition Expense

Acquisition expenses are generally not tax deductible to the buyer in Singapore. Thus, it is important to book such expenses in a country where an appropriate tax deduction may be available.

Treatment of Goodwill

A tax deduction is not allowable for goodwill expenses or amortisation of such goodwill. However, interest on funds borrowed to acquire the goodwill should be tax deductible.

For financial buyers who require a good exit multiple through an IPO, the goodwill needs to be housed in an appropriate vehicle to avoid diluting the group profits on which the IPO price may be based. There are no restrictions as to the transfer of 'goodwill' to an entity outside Singapore. Such 'goodwill' may be packaged such that a foreign acquirer may obtain a tax deduction for the purchased goodwill and on-charge the Singapore company a fee for benefiting from the use of the goodwill.

Manufacturers are eligible to claim a deduction on a straight-line basis over a period of 5 years in respect of the capital cost incurred in acquiring approved know-how or patent rights for the purpose of their trade. This deduction has been extended to the non-manufacturing sector in respect of costs incurred on or after 23 February 2001 on the acquisition of intellectual property rights (i.e. patent, copyrights, trademarks, registered designs etc).

The approval for know-how and patent rights is granted by the Economic Development Board (EDB) in respect of the manufacturing and trading sector and by the Infocom Development Authority (IDA) for the technology sector. The qualifying criteria are:

a) The company should be the sole legal and economic owner of the rights.
b) The rights should be used for activities based in Singapore.
c) The company should use the rights in its business by the third year of acquisition.
d) The company should commit an incremental Total Business Spending (TBS) equivalent to 30% of the cost of the rights over the 5 year writing-down period. The incremental TBS should be incurred on activities that involve the use of the rights acquired.
e) All transactions should be concluded at arm's length and applicants should submit an independent valuation report (e.g. from a public accounting firm) if the purchase price of the rights exceeds S$1 million for related party transactions or S$5 million for non-related party transactions. Certification of the legal ownership of the rights by a law firm should also be produced upon request by the EDB or IDA.

EXIT ROUTE

For Singapore income tax purposes, there is generally no essential difference whether the acquirer is a local or foreign entity. However, as a foreign acquirer, it would have to consider the group's overall tax effect of the deal (i.e. local taxes and home country tax implications).

In addition, where the acquirer is a foreign entity, there may be avenues whereby the profits of the target company may be repatriated to the home country by means other than dividends. These include the payment of licence fees, royalties, interest and management fees. However, the payment of such amounts may be subject to withholding taxes as follows:

	Tax Rate (%)
Management fees	24.5
Interest	15
Royalties	15
Technical assistance/service fees	24.5

Appropriate tax treaties may reduce the withholding tax rates. For example, payment of interest to a Mauritius entity is not subject to withholding tax provided certain conditions are met. Management fees in consideration for services rendered outside Singapore that are recharged at costs should not be subject to withholding tax or should not be taxed if an appropriate double tax agreement operates to exempt the fee from tax due to the non-existence of a permanent establishment in Singapore. Singapore tax legislation does not have any specific anti-treaty shopping provisions and where an arrangement (with commercial substance) takes advantage of a tax treaty, the reduced rate provided under that treaty should generally prevail.

If, at the time of acquisition, it was intended that the return on investment would be maximised by way of a sale, profits on the sale of shares or assets (usually in the form of goodwill) may be regarded as income subject to tax. Similarly, where it is intended that non-core businesses will be disposed for a gain subsequent to the acquisition, the resulting profit may be income subject to tax. In this event, it would be appropriate to structure the acquisition such that the profit is located in a tax haven country or other appropriate location to minimise tax on such profits.

After acquiring a target, a financial buyer generally looks for an exit route either through a sale or an IPO. Since the objectives of a financial buyer are to maximise its return on investment and optimise its exit multiples, any profits derived from the exit route through an asset or share sale are generally regarded as income subject to tax. To realise profits in a tax efficient manner, an appropriate structure should be put in place to effect the acquisition.

If the group's main income is generated from Singapore, it may seek a Singapore currency listing. As such, the listed vehicle which can also be the acquisition vehicle should be incorporated in Singapore. Technically, profits derived from an IPO by a financial buyer may be subject to tax in Singapore as the gains would be regarded as income. However, where the shares are held through a company resident in say, Mauritius, the gain should not be taxable in Singapore as provided under the Mauritius-Singapore Double Tax Agreement.

If the group is seeking a foreign currency listing in Singapore (i.e. where the majority of its income is generated outside Singapore) or listing outside Singapore, there is no requirement to have the listed vehicle incorporated in Singapore. As such, it may be appropriate for the listed vehicle to be incorporated in say, Bermuda or other tax havens. Such a structure will enable the financial buyer to exit through an IPO in a tax-efficient manner.

The tax consequences of sales by a financial buyer of shares in a target company are similar to those stated above.

ENDING REMARKS - PREPARATION FOR A DEAL

Asia has seen an increasing volume of activities in mergers & acquisitions. This is mainly due to the liberalisation of foreign ownership requirements on local businesses by governments and the relatively attractive prices. However, buyers are encouraged to carry out proper due diligence of the targets to minimise risks. Additionally, buyers can improve shareholder values and returns on investment through tax efficient structuring and planning.

SRI LANKA

Country M&A Team

Country Leader ~ Daya Weerarath
Hiranthi Ratnayake

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GENERAL INFORMATION

(i) Introduction

Tax residents of Sri Lanka are taxed on their worldwide income. Non-residents are taxed only on their profits and income arising in, or derived from, Sri Lanka, which are defined to include all profits and income derived from services rendered in Sri Lanka, or from property in Sri Lanka, or from business transacted in Sri Lanka, whether directly or through an agent.

(ii) Common Forms of Business Entity

Business may be conducted in Sri Lanka in any of the following forms:

- company incorporated in Sri Lanka;
- private;
- public;
- quoted;
- branch office of a foreign company;
- representative or liaison office of a foreign company;
- partnership;
- sole proprietorship; or
- offshore company.

The private limited liability companies and branches of foreign companies are the types of business entities most commonly used by foreign investors. Certain tax concessions are available to foreign investors, depending on the amount of investment and type of business activity carried out in Sri Lanka.

(iii) Foreign Ownership Restrictions

Since the opening up of Sri Lanka's economy in 1977, the country has adopted a policy of encouraging foreign investment. Except for investment in certain business activities (see below), foreign investors are permitted to set up wholly-owned subsidiaries in Sri Lanka.

The following businesses are restricted to citizens of Sri Lanka:

– money lending;
– pawn broking;
– retail trade with a capital of less than US$1m;
– business of providing personal services other than in the export sector or the tourism sector; and
– coastal fishing.

Foreign investments established for purposes listed below require the approval of the respective regulatory authorities, which may specify the extent of foreign ownership:

– banking;
– financing;
– insurance;
– trading services on the Colombo Stock Exchange;
– air transportation;
– coastal shipping;
– industrial undertakings in the second schedule of the Industrial Promotion Act No. 46 of 1990, namely,
  - any industry manufacturing arms, ammunition, explosives, military vehicles and equipment, aircraft and other military hardware,
  - any industry manufacturing poisons, narcotics, alcohol, dangerous drugs and toxic, hazardous or carcinogenic materials, and
  - any industry producing currency, coins or security documents;
– production and distribution of energy and power;
– large scale mechanised mining of gems; and
– lotteries.

Foreign investments are permitted up to 49% of the equity in a company carrying on the business activity set out below although it is possible to obtain the approval from the Board of Investment of Sri Lanka (BOI) for a higher foreign equity on a case-by-case basis:

– production of goods where Sri Lanka's exports are subject to internationally determined quota restrictions;
– growing and primary processing of tea, rubber, coconut, cocoa, rice, sugar and spices;
– mining and primary processing of non-renewable national resources;
– timber based industries using local timber;
– fishing (deep sea fishing);
– construction of residential buildings;
– supply of water;
– mass transportation;
– telecommunications;

– mass communications;
– education;
– professional services;
– freight forwarding;
– travel agencies; and
– shipping agencies.

(iv) Tax Rates

A resident company, for purposes of tax, is one which has its registered or principal office in Sri Lanka or whose business is managed or controlled from Sri Lanka. The rate of income tax for resident companies is 35%. A lower rate of 15% applies to profits from exports, agriculture, fisheries, tourism and construction.

Resident companies, except quoted public companies paying dividends to resident shareholders, are required to withhold 15% from the gross dividends payable to shareholders and the tax withheld is required to be paid to the Sri Lanka tax authorities within 30 days of distribution of the dividends.

In addition, a resident company is required to pay Advance Company Tax (ACT) at the rate of 27% if the company is unquoted and at 54% if it is quoted on every qualifying distribution made out of taxable profits. The ACT is creditable against the company's income tax of 35% and any unrelieved excess is available for set off against its income tax liability of subsequent years. ACT is not payable on dividends paid to non-resident shareholders.

Non-resident companies are liable to income tax at 35% of its taxable income. Where profits are remitted, an additional tax which is the lower of a third of profits remitted abroad or a ninth of taxable income, is imposed.

Withholding Tax

Dividend, interest, rent, royalties and service fees paid by a resident company are subject to withholding tax. The rates are as follows:

	Recipient	
Nature of Payment	Resident Rate (%)	Non-Resident Rate (%)
Dividends (by non-quoted companies)	15	15
Dividends (by quoted companies)	-	15
Rent and royalties	-	20
Interest (paid by non-financial institutions)	-	20
Interest (paid by financial institutions)	10	10
Service fees	5	5

The withholding tax applicable to a non-resident may be reduced or exempt under certain double tax treaties.

(v) Taxation of Dividends

Dividends are generally subject to a withholding tax of 15% of the gross dividend unless otherwise distributed out of tax-exempt profits or distributed to a non-resident shareholder by a company which has entered into an agreement with the Board of Investment of Sri Lanka (BOI) under Section 17 of the BOI Law No 4 of 1978, prior to 31 December 1994, on an application made on that behalf prior to 11 November 1993.

Corporate shareholders are not required to include dividends in their assessable income if the dividends are paid by a resident company which has deducted tax from the dividends or the dividends are paid out from dividends received from another resident company. Individual shareholders are required to include the gross dividends received in their statutory income but are entitled to a credit against their liability any tax withheld from such dividends.

Sri Lanka also adopts an imputation system for taxation of qualified dividends. The imputation system applies to qualifying distributions, defined as gross dividends paid by a resident company. On making a qualifying distribution to resident shareholders, a company is required to pay ACT, which is creditable against the income tax payable by that company. A resident shareholder receiving a qualifying distribution is required to declare the gross amount of the distribution including the attributable ACT, and is entitled to deduct the ACT from the income tax payable by such shareholder.

(vi) Tax Losses

Tax losses may be carried forward indefinitely until the tax year 1997/98. Consequent to a major legislative change, certain limitations are placed on carried forward losses for the tax year 1997/98 and subsequent years. The rules are as follows:

1) Loss incurred on or after 1 April 1997 and attributable to capital allowances may be carried forward indefinitely.
2) Loss incurred on or after 1 April 1997 from agricultural business (other than the component attributable to capital allowances) can be carried forward for a period of 12 years including the year in which the loss was incurred.
3) Loss incurred on or after 1 April 1997 other than (1) and (2) above, can be carried forward for a period of 7 years, including the year in which the loss was incurred.
4) Balance of losses brought forward to the tax year 1997/98 is deemed to be a loss incurred in the year 1997/98 and can be carried forward subject to the restrictions in (2) and (3) above.

Losses may be disallowed if there has been a major change in the ownership of the company shareholding and the nature of its activity. The tax statute provides that, where more than one third of the issued share capital of the company is held at any time in the tax year, in which the loss is deductible by persons who did not hold such share capital at any time in the tax year in which the loss was incurred, the loss may only be deductible from the profits of the same business. This provision is unlikely to be invoked for a commercially-driven acquisition/restructuring.

There is no group taxation in Sri Lanka. Therefore, tax losses incurred by one company may not be set off against taxable profits of another group company.

(vii) Thin Capitalisation

Sri Lanka has no rules with regard to thin capitalisation. However for financial institutions, there are legislations providing for minimum capital and capital adequacy ratio. Further, since Sri Lanka's capital account is still regulated, there are restrictions on the use of overseas debt to acquire investments in Sri Lanka.

(viii) Other Taxes

Goods and Services Tax (GST), in force from 1 April 1998, is charged at the time of supply, at 12.5%, on the value of goods imported by any person and on the value of the local supply of goods or services made by a registered person.

National Security Levy, which is intended to be a time-bound tax, is charged on

- articles imported;
- sales turnover of a manufacturer;
- turnover of an insurance, banking or finance business;
- turnover of a telecommunication service provider; and
- turnover of a provider of a service of any description other than certain exempted services.

The current rates are 0.5% on capital goods and 6.5% on others.

Excise duties and Special Excise Levies are charged on tobacco, cigarettes, liquor, motor vehicles and selected petroleum products.

Stamp duty of 0.5% is payable at par value on a new share issued by a company, while stamp duty of 1% is payable by the purchaser on a transfer of shares on the purchase price or market value, whichever is higher. There is no liability to stamp duty on the transfer of the quoted public company shares. Stamp duty is also payable by the purchaser at 3% on the first Rs100,000 and 4% on the balance consideration (or market value in the absence of a consideration) in excess of Rs100,000 when acquiring immovable property. Purchase of a movable property for which a deed is executed attracts a stamp duty of 3% on the consideration or on the market value in the absence of a consideration.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

Profit on Sale of Share

A seller will be chargeable with income tax on the capital gains, if any, derived from the sale of shares. The rates of income tax on such capital gains depend on period of ownership of such shares, and are as follows:

Period of ownership	Rates (%)
Over 25 years	0
Between 20 and 25 years	5.0
Between 15 and 20 years	12.5
Between 5 and 15 years	17.5
Between 2 and 5 years	25.0
Less than 2 years	35.0

The recognition of capital gains arising from amalgamation or merger of two or more companies will be deferred (other than that part relating to any money received by a shareholder in consequence of such amalgamation or merger) until such time when the new shares received in exchange for shares in the company which was amalgamated or merged, are disposed of. In computing the capital gains on disposal of such new shares, the cost of acquisition will be the purchase price or market value on date of acquisition of the original shares.

There is no liability to income tax on capital gains arising on transfers of quoted public company shares or shares of a company which has entered into an agreement with Board of Investment of Sri Lanka under section 17 of the Board of Investment Law No. 4 of 1978.

(ii) Buyer's Perspective

Stamp Duty

The stamp duty on transfer of shares is payable by the buyer. The rate of stamp duty on transfer of shares is 1% of the consideration or the open market value of the shares, whichever is higher. Stamp duty is not chargeable on transfer of listed company shares.

Funding Costs

Prospective buyers could utilise domestic loans to fund an acquisition. There are, however, restrictions placed on Sri Lankan companies raising debt from overseas.

Interest on loans and overdrafts is deductible only if it is incurred as an outgoing or expense in earning profits and income in any trade, business, profession or vocation. Interest not incurred directly in the earning of profits of a business is still deductible, if such loan is used to finance the purchase of shares in any company, purchase of any building, or for the purchase of a site for the construction of any building. Therefore, interest paid on debts incurred for the purpose of acquiring shares would be tax deductible to the owner of the business entity.

Acquisition Expenses

Acquisition expenses should be capitalised as cost of acquiring the shares and will be deductible in computing the capital gains on future disposal of such shares.

Preservation of Tax Losses

Where there has been a change in the ownership of the acquired company by more than 33 1/3%, the carry-forward losses may only be set off against the profits derived from the same business.

Preservation of Tax Depreciation

A change in the ownership of a company does not have any impact on the capital allowances claimed or claimable by the company concerned.

Tax Incentives

Currently, there are no tax incentives applicable on purchase of shares of Sri Lankan companies. However, with respect to listed company shares, exemption is given in respect of income tax on the capital gains arising from the sale of shares and in respect of stamp duty payable on the transfer of the shares.

Any tax incentives available to the acquired company will continue despite the change of ownership.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

Profit on Sale of Assets

An asset deal will involve the disposal of assets on which depreciation for tax purposes has been deducted and the disposal of assets on which tax depreciation has not been deducted.

The profit from the disposal of assets on which tax depreciation has been deducted consist of two parts: a balancing charge which is taxed at normal rates as part of business profits and a capital gain from the disposal of the same assets. The balancing charge is computed by taking the difference between the sale price or cost, whichever is lower, and the tax written down of the asset. Any excess of the sale price over the cost of the asset is subject to tax as a capital gain.

The profit from the disposal of assets (tangible and intangible) on which tax depreciation has not been deducted is assessed as a capital gain.

The assets should be transferred at their open market value. In certain circumstances, in respect of depreciable assets the tax authorities may accept a valuation based on the tax written down value.

Goods and Services Tax (GST)

The sale of assets will be subject to 12 1/2% GST charged on the consideration for the assets sold. The seller has to charge and account for GST to the tax authorities. However, if buyer is GST registered, the buyer is entitled to claim a credit in respect of the GST paid. The sale of the assets will not be subject to GST provided they are sold as part of a going concern.

(ii) Buyer's Perspective

Acquisition Structure

Generally, the buyer will establish a locally-incorporated company in Sri Lanka through which the assets would be acquired. In the case of acquisition of real estate, such acquisition may only be achieved via a locally incorporated company.

Funding Costs

Interest on loans utilised to finance the acquisition of assets is generally deductible in computing the profits chargeable with tax, provided the assets are used in producing income.

Acquisition Costs

The cost incurred in acquiring assets should be added to the purchase price of the assets acquired.

Treatment Of Goodwill

Under the current tax rules, no tax deduction is available for the acquisition of goodwill. Hence, an asset purchase involving a substantial payment for goodwill may not be tax efficient.

Goods and Services Tax (GST)

Provided the buyer is GST registered, it would be able to claim the GST suffered on the assets acquired as input GST against his output GST.

Stamp Duty

Stamp duty has to be borne by the buyer on the acquisition of the assets. With respect to immovable property, an instrument of transfer (deed) has to be executed and the amount of stamp duty is calculated at 3% on first Rs100,000 and at 4% on the balance. An instrument evidencing the transfer of movable assets is dutiable at 3% of the consideration. However, such transfer could be made on an ordinary sale invoice (GST invoice), thereby avoiding the exposure to the stamp duty.

EXIT ROUTE

Generally, when the investor wants to exit, he may sell his investment through a share or asset deal. Where a non-resident investor is selling shares in a Sri Lanka company, the investor will be exposed to liability to income tax on any capital gains arising and also to stamp duty. The potential exposure to income tax on the capital gains derived from the sale of shares could be mitigated by:

- listing the shares of the target company and making the sale after the listing; or
- holding the investment through a company located in a country with which Sri Lanka has a double tax treaty and such treaty exempts Sri Lankan tax on the capital gains; or
- holding the investment through a company located in a tax haven country and when the Sri Lanka investment is to be sold, the company in the tax haven to be sold instead.

Listing the shares of the target company will also avoid exposure to stamp duty on subsequent transfers of shares.

If the exit is via a sale of assets, the seller will be liable to GST and to income tax on the profit on sale. From a tax efficiency perspective, a share deal is the preferred route.

Avenues by which profits of the target company could be repatriated to the home country (other than by way of dividends), include such payouts as interest, royalties, technical and management fees. However, the tax authorities may disapprove payments in excess of what is considered reasonable and commercially justifiable.

ENDING REMARKS - PREPARATION FOR A DEAL

(i) Seller's Perspective

A seller may consider structuring the sale of shares through a 'share for share' mechanism as this may defer liability to capital gains.

(ii) Buyer's Perspective

A buyer would find a share deal a more viable option from a tax efficiency perspective. However, irrespective of the structure of a deal, careful planning, including a due diligence of the target company, is essential to ensure that investment objectives would be achieved and 'minimum tax' exit mechanisms could be put in place.

TAIWAN

Country M&A Team

Country Leader ~ Steven Go
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SECTIONS

GENERAL INFORMATION

(i) Introduction

The income tax regime in Taiwan is divided into personal consolidated income tax for individuals (individual tax), and profit-seeking enterprise income tax for business enterprises (business enterprise tax or corporate tax). The term 'business enterprise' refers to an entity that engages in profit-seeking activities, including sole proprietorship, partnership, company, or any other form of organisation that is organised for profit-seeking purposes.

A resident corporate taxpayer is subject to income tax on its worldwide income. For non-resident corporate taxpayers, including those that do not have a permanent establishment (PE) in Taiwan, only Taiwan source income is subject to tax in Taiwan (normally in a form of withholding tax). If a foreign corporation establishes a PE or fixed place of business in Taiwan (e.g. branch), it is subject to the same tax rates as those applicable to a resident corporate taxpayer.

Foreign exchange control regulations restrict the outward remittance of funds exceeding a certain amount. A resident individual is allowed to remit outward funds up to US$5m per annum without obtaining a prior approval from the Central Bank of China. However, if any single remittance is in excess of US$1m, the bank may seek consent from the Central Bank of China before remittance. A resident corporation is allowed to remit outward funds up to US$50m per annum without obtaining a prior approval from the Central Bank of China. However, Foreign Investment Approved (FIA) investors or Qualified/General Foreign Institutional Investors (QFII/GFII) may remit capital/income overseas freely.

Overseas investment shall be reported to the Investment Commission of the Ministry of Economic Affairs (ICMOEA). Nonetheless, any overseas investment above US$50m overseas investment requires a prior approval from the ICMOEA. Any investment in the People's Republic of China (even if the investment is made through a third country) requires a prior approval from the ICMOEA.

In order to increase the global competitiveness of Taiwanese enterprises, the Taiwan government has enacted the Enterprise Merger and Acquisition Law (EMAL), the Financial Institution Merger Law (FIML) or the Financial Holding Company Law (FHCL) and amended the Company Law and the Statue for Upgrading Industries in 2001 and 2002, which provide various tax incentives to merger and acquisition transactions of Taiwan companies. The details will be described in the later sections.

(ii) Common Forms of Business Entity

The most common forms of business entity available to foreign investors are locally incorporated corporations or branches. Incorporation of local corporations should be approved by the ICMOEA and are generally referred to as FIA companies.

FIA companies may enjoy privileges such as waiver of domicile and nationality requirements of shareholders, directors and supervisors, permission to repatriate invested capital and profits without restrictions, and reduction in dividend withholding tax.

A FIA company may be a 'Company Limited by Shares' (at least two shareholders or one government/legal entity shareholder) or a 'Limited Company' (at least one shareholder). A limited company may enjoy 'check the box' rules for US income tax purposes.

(iii) Foreign Ownership Restrictions

Generally, there are no restriction on foreign ownership except for prohibited industries and restricted industries. The former include such industries as may endanger public security, be contrary to local custom, cause high level of pollution, or be by nature monopolistic. The latter consist of such industries as banking, insurance, broadcasting, publication and those restricted by law. Nonetheless, on Taiwan's accession to WTO, those restricted industries will be further open to foreign investors.

(iv) Tax Rates

Corporate Tax

Taiwanese corporations and foreign corporations operating in Taiwan through PE or branches are subject to progressive corporate tax rates depending on their level of taxable income. Below is a table of progressive corporate tax rates.

Taxable Income	Tax
Up to NT$50,000	exempt
NT$50,001 to NT$71,428	50% of taxable income, less NT$25,000
NT$71,429 to NT$100,000	15% of taxable income
NT$100,001 and over	25% of taxable income, less NT$10,000

Withholding Tax

Payments made to foreign recipients (which do not have a PE in Taiwan) will normally be subject to withholding tax at the following rates:

Type of Income	Withholding Tax Rates (%)
Dividends	30/25/20
Interest	20
Royalties	20 or Nil (for approved royalty)
Service Fees/Rental	20 or 3.75 (for approved technical services/equipment lease/construction)
Commission	20
Other	20 or 2.5 (for approved international transportation services) or 25 (for gain on sale of property)

Dividends paid by a FIA company to a foreign shareholder are taxed at 20%. Dividends paid by a non-FIA company to a foreign corporate shareholder are taxed at 25% and to a foreign individual are taxed at 30%.

Withholding tax rates on dividends, interest and royalties may be reduced if a recipient is based in one of the tax treaty countries and the relevant treaty provides for a reduced rate. Taiwan has entered into comprehensive tax treaties with Australia, New Zealand, Indonesia, Singapore, Malaysia, Vietnam, South Africa, Swaziland, Gambia, Macedonia, and the Netherlands.

A Taiwan branch of an overseas company may remit after-tax profits of its head office without any further Taiwan tax.

(v) Taxation of Dividends

Taiwan adopts the imputation tax system in relation to the taxation of dividend income. The system is designed to reduce the overall tax liabilities by a shareholder in respect of dividends, which have effectively suffered corporate tax (on corporation level) and personal consolidated income tax (on individual level). Under this system, for dividends received from a Taiwan corporation out of profits which have been subject to corporate tax, a resident individual shareholder is entitled to offset the company's actual underlying corporate tax paid against his/her own personal consolidated income tax liabilities. As a result, the effective tax rate for a resident individual taxpayer with the highest marginal rate may be reduced from 55% to 40% on such dividends.

Domestic dividends received by a corporate shareholder are exempt from tax in the hands of such shareholder. Any dividends paid by such a corporate shareholder to its individual shareholders would, in turn, carry the underlying tax credit for corporate tax paid by its subsidiary.

A 10% profit retention tax may be imposed on any part of the current year's profit (after statutory reserves) that is not distributed. This rule also applies to FIA subsidiaries. This additional tax paid by the company can be used by a resident individual shareholder to offset against the shareholder's tax liabilities once the company distributes dividends from the corresponding undistributed earnings in subsequent years.

For non-resident shareholders, the 10% profit retention tax may be credited against the dividend withholding tax once the company distributes dividends from the corresponding retained earnings in subsequent years. Effectively, the imputation tax system has little impact on foreign investors.

(vi) Tax Losses

Net operating loss (NOL) may be carried forward for 5 years if the company's income tax return is certified by a certified public accountant or it has received an approval to use a blue form income tax return and if it maintains complete and adequate accounting records.

Generally, where two or more companies merge, the NOLs of all the companies are not allowed to be carried forward even if one of the companies is the surviving entity. However, according to the EMAL, the FIML or the FHCL, a portion of NOL of the acquired company may be allowed to be carried over to the acquiring company if the prescribed requirements are met. The allowable carryover amount is determined by the percentage of shares in the acquiring company held by shareholders of the acquired company.

(vii) Thin Capitalisation

Equity falls into two categories, namely common share and preferred share. Taiwan does not impose any thin-capitalisation rules. However, the minimum equity capital is NT$1m for a Company Limited by Shares and NT$500,000 for a Limited Company.

(viii) Other Taxes

Securities Transaction Tax

Currently, capital gains resulting from disposal of Taiwanese securities (e.g. shares of a Taiwanese company organised as a 'company limited by shares') are exempt from income tax. However, securities transaction tax is levied at the rate of 0.3% on gross proceeds received from the disposition, and 0.1% on the trade value of warrants and beneficiary certificates. Sale of government bonds, corporate bonds/debentures and bank bonds is exempt from securities transaction tax.

VAT

The Value-Added Type and Non-Value-Added Type Business Tax Law (Business Tax Law) states that the VAT shall be levied on the sale of goods or services within Taiwan and the import of goods. All goods and services supplied for domestic consumption by a VAT-registered entity are liable to VAT at the prevailing rate of 5%. Export of goods and the performance of international services are zero-rated. Furthermore, certain goods and services such as gold, agriculture products and certain publications may be exempt from VAT. Effective on January 1, 2002, a 5% import VAT is imposed on goods imported.

VAT is applicable to assets transferred in a merger or acquisition. The EMAL provides for VAT exemption.

For certain industries, such as banking, insurance, trust, investment, securities and pawnshop, the gross business receipt tax (Non-Value-Added Tax) system would apply.

Stamp Tax

Stamp tax is levied on receipts of money and agreements at 0.4% of the amount received and 0.1% of the contract price, respectively. Stamp duty for the transfer of real property is 0.1% of the value announced by the government. Contracts for sale of movable property are subject to stamp tax at NT$12 per contract. However, if a contract relates to sales of both moveable and supply of service, the higher rate of 0.1% will apply to whole value of the contract.

(ix) Merger or Consolidation Tax Incentives

The Statute for Upgrading Industries provides for the following tax incentives:

- The stamp duty, the deed tax, the securities transaction tax and the VAT arising from the merger or consolidation are exempt.
- The payment of land value increment tax is deferred until the next transfer of the land.
- A portion of NOL of the dissolved company can be carried over to the surviving or newly established company.
- Unutilised tax incentives of the dissolved company can be carried over to the surviving or newly established company, subject to some limitations.

Furthermore, the EMAL, the FIML or the FHCL provide various tax incentives on M&A activities.

(x) Tax Incentives

A majority of the available tax incentives, subject to the prior approval of the relevant in-charge authorities, are prescribed in the revised Statute for Upgrading Industries, and are available to companies established pursuant to the Company Law of Taiwan. Qualified companies in emerging, important and strategic industries may enjoy a 5-year tax holiday. The tax holiday period may commence (subject to an election made within the first 2 years of operation) no later than the fifth year of operation.

If the company elects not to enjoy the said 5-year tax holiday, its shareholders may, if they hold the relevant shares for more than 3 years, claim a deduction against their income tax liabilities up to 20% (for corporate shareholders) or 9% (for individual shareholders) of the investment amount.

In addition to the tax holiday, an approved company may be eligible to tax credits for, inter alia, R&D expenses, training expenses, costs of acquiring automation and anti-pollution equipment.

STRUCTURING A SHARE DEAL

Generally, a stock purchase may be structured so that the buyer itself, or through a newly established company, purchases the stock of the target company from its shareholders.

(i) Seller's Perspective

Gains derived from sales by the seller of a target company's shares are exempt from income tax and losses suffered are not tax deductible. However, the sales are subject to securities transaction tax of 0.3% on the proceeds from the share transfer. Such tax is borne by the seller. The Statute for Upgrading Industries and the EMAL exempt the securities transaction tax arising from M&A activities if prescribed requirements are met or a prior approval is obtained.

Accordingly, for a shareholder of the target company, a share purchase may be the most tax efficient way to reap the gains from its investment. In the event that the target company has a considerable amount of undistributed earnings, by selling its shares in the target company at a fair market value (which should include the value of the undistributed earnings), the seller effectively receive all the gains from the disposal, tax-free.

(ii) Buyer's Perspective

From the buyer's point of view, generally, a stock purchase transaction can be structured in two different ways: (1) purchase the shares directly from the shareholders of the target company; or (2) purchase target company's shares through a newly established Taiwan company. Note that a branch office of a foreign entity is generally not permitted to acquire the shares of a target company.

Prior to executing the share transfer, if the buyer of the target company's shares is a foreign entity, approval from the ICMOEA should be sought. Once the approval is obtained, both parties may proceed with the share transfer.

Acquisition Structure

Typically, a foreign investor would directly acquire a target or set up a holding company in Taiwan to acquire the target.

Funding Cost

The interest incurred by a foreign investor on purchase of shares in a Taiwan target is not tax deductible against the dividend income.

The foreign investor may set up a holding company in Taiwan and obtain funds locally to finance the acquisition with an aim to reducing the amount of future dividend withholding tax.

Preservation of NOL credit and Incentives

After the share deal, the target company can continue to enjoy the NOL credit and the incentives that have been granted before the share deal but not yet used.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

Generally, the capital gains arising from a sale of assets, including intangibles, are taxable at a corporate income tax rate of 25% (see below for exemption). If the seller has NOL, the capital gains may be offset against the NOL. Gains from sales of land are exempt from corporate income tax, but are subject to land value increment tax. The land value increment tax is levied on the increase in the government-announced value and applicable progressive tax rates are from 40% through 60%. The gain on sale of Taiwanese marketable securities is also tax exempt.

The above-said capital gains may be exempted from tax if prescribed requirements are met, pursuant to some laws, such as the EMAL.

In some instance, utilised tax credits may be clawed back. For example, tax credits are granted to the cost of acquiring automated equipment. However, when the qualified equipment is sold within a specific time period, the tax credits already used shall be "recaptured" and the company shall be liable for the corresponding tax due.

The seller is required to issue Government Uniform Invoice and charge VAT at the rate of 5% to the buyer for sale of some assets, such as inventories and fixed assets. The buyer may claim VAT refund for VAT paid relating to the purchase of fixed assets. VAT paid in relation to other assets is creditable against output VAT. The sale of land and marketable securities is exempt from VAT. Furthermore, VAT may exempt pursuant to some laws, such as the EMAL.

(ii) Buyer's Perspective

Funding Cost

As there is no thin-capitalisation rule, the determination of an appropriate debt/equity structure should be based on commercial considerations. Interest incurred on funds used to acquire fixed assets generally needs to be capitalised but amortised in accordance with the nature of the assets.

Furthermore, since capital gains arising from sale of land and marketable securities are exempt from income tax, the related interest and expenses for the purchase of the land and marketable securities are not deductible.

Basis Step-Up/Treatment of Goodwill

An asset deal allows the buyer to step up the basis of acquired assets for tax purposes, thus, enabling the buyer to reduce its future tax liability through depreciation of the fixed assets or amortisation of the intangibles, which is not available in a share deal. The difference between the consideration price paid and the fair market value (or, in some cases, the book value) of the assets transferred may be recognised as operating right or goodwill. The minimum amortisation period is 10 years for operating right and 5 years for goodwill

Taxes

In addition to the 5% VAT imposed on the purchase of assets, the buyer pays the title deed tax and the stamp duty for transfer of title of real estates and the securities transaction tax for purchase of marketable securities. The title deed tax is imposed at 6% of government-assessed value of the buildings acquired. The stamp duty for the contract for transfer of real estates is levied at 0.1% of the government-assessed value. The securities transaction tax rate is 0.3% for stock shares and 0.1% for others such as mutual fund certificates.

However, the above taxes may be exempted under some laws such as the EMAL.

EXIT ROUTE

Generally, the foreign buyer elects the sale of shares or assets or the liquidation of the entity in Taiwan to exit from Taiwan market.

Share/Asset Sale

As indicated above, a sale of a Taiwan company's shares is subject to the 0.3% securities transaction tax and any gains there from are exempt from income tax. On the other hand, any gain derived from the sale of the assets by the target company is subject to corporate income tax. In addition, the dividends eventually distributed to the foreign shareholders are subject to withholding tax.

Asset Sale and Liquidation

Alternatively, a seller may sell all of the assets and, thereafter, liquidate the Taiwan company. The sale of assets may incur capital gains tax, land value increment tax, securities transaction tax, stamp duty and VAT. In addition, the excess of the residual assets repatriated to the shareholder over the investment amount is taxable to the shareholder.

Prior to dissolving the company, the foreign investor should seek approval of the withdrawal of foreign investments.

Furthermore, the foreign buyer can consider other alternatives such as capital reduction, IPO, and profit repatriation by the name of dividends, fees, royalties, or interest to channel the funds to the home country.

ENDING REMARKS - PREPARATION FOR A DEAL

Besides the finance and business due diligence, the buyer is encouraged to perform the tax due diligence to identify the tax risk and the tax opportunity. Due to the rapid change in laws and regulations, the parties involved in the M&A deals should carefully plan the deal structure to secure tax benefits/exemption and to comply with statutory requirements.

THAILAND

Country M&A Team

Country Leader ~ Sira Intarakumthornchai
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SECTIONS

GENERAL INFORMATION

Domestic corporations are subject to corporate income tax on their worldwide income. Double taxation agreements permit tax paid in a foreign country to be credited against Thai tax payable on the relevant income. For branch income and dividends, credit for foreign tax is also available under unilateral provisions. In cases where foreign tax is not creditable, such tax may be allowed as a deductible expense. Foreign corporations are only taxed on their income earned in Thailand. Capital gains are taxable as ordinary income.

(i) Introduction

M&A transactions may give rise to liabilities to a number of taxes in Thailand, including corporate income tax, value added tax, specific business tax and stamp duties. However, exemptions from taxes are available in certain circumstances. Recent tax incentives being granted include (1) a package of tax privileges (reduction/exemption from corporate income tax and/or personal income tax) to the Regional Operating Headquarters (ROH) being established in Thailand, (2) a reduction in the corporate income tax to the existing companies and new companies listed on the Stock Exchange of Thailand (SET) and new companies listed on the Market for Alternative Investment (MAI). MAI is a newly established trading board. Appropriate and timely tax planning may significantly reduce the tax costs associated with a deal.

(ii) Common Forms of Business Entity

The most common form of business entity in Thailand is the limited liability company. Liability of shareholders in a limited liability company is restricted to the amount of unpaid capital.

Other forms of business entity include:

- General (unlimited) partnership
- Limited partnership
- Branch of a foreign corporation
- Joint venture
- Property and equity funds

(iii) Foreign Ownership Restrictions

Foreign investment is governed in Thailand by the Alien Business Act (ABA). The ABA restricts the extent to which 'Aliens' may engage in certain types of business in Thailand. Not all businesses are subject to restrictions of foreign ownership. In particular, most forms of manufacturing are open to majority foreign ownership.

Foreign ownership restrictions under the ABA may be removed in a number of circumstances, for example:

- under investment promotion privileges granted by the Thai Board of Investment;
- in the case of US-owned enterprises, under the provisions of the Treaty of Amity and Economic Relations between Thailand and the USA; and
- by investing via a property or equity fund, which is treated as 'Thai' under the law.

Where these exemptions do not apply, ownership of an enterprise in Thailand may be structured in a manner that complies with the restrictions under the ABA whilst providing the foreign investor with voting control and entitlement to the economic benefits of the enterprise.

In addition to restrictions on foreign ownership of businesses, Thailand does not permit foreign ownership of land, other than that under investment promotion privileges granted by the Board of Investment.

(iv) Tax Rates

a) Corporate Tax

A juristic company or partnership incorporated in Thailand is subject to corporate income tax at the rate of 30% on its worldwide income. The corporate income tax may be reduced under the following cases:

(1) The Regional Operating Headquarters (ROH) established in Thailand

Provided that certain qualifications are met, the ROH is subject to the corporate income tax at the rate of 10% on certain income streams. Exemption is also granted to dividends received from its domestic and overseas affiliated companies.

(2) Existing listed companies on the SET

A corporate income tax at the rate of 25% is imposed on the first Baht 300 million of net profit. The normal rate of 30% is imposed on the balance of the net profit.

(3) New listed companies on the SET

A corporate income tax at the rate of 25% shall apply to all the net profits.

(4) New listed companies on the MAI

A corporate income tax at the rate of 20% shall apply to all the net profits.

The reduced rates under (2), (3) and (4) above shall be applicable only for five accounting periods.

b) Withholding Tax

A foreign company that does not carry on business in Thailand is subject to final withholding tax on the following categories of income derived from Thailand:

- dividend;
- brokerage, fees for provision of services;
- royalties;
- interest; and
- rental of property

Withholding tax is imposed at the rate of 15% on the remittance of all of the above types of income or profits, except dividends (which is subject to withholding tax of 10%). The rate of withholding tax may be reduced under a double taxation agreement. In most cases, double taxation agreements will exempt brokerage and service fees from Thai tax. The rate of withholding tax on interest may be reduced to 10% if paid to a foreign financial institution. The rate of withholding tax on copyright royalties is reduced to 5% under most double taxation agreements. However, no double taxation agreement reduces the rate of withholding tax on dividends to below the domestic rate of 10%.

Dividends paid from the ROH to a foreign company or partnership is exempt from withholding tax.

(v) Taxation of Dividends

Dividends paid between Thai companies are exempt from tax if the recipient is either:

- a company listed on the SET; or
- a company that holds at least 25% of the voting shares in the dividend paying company

If the dividend is not exempt from tax, it may nevertheless qualify for partial exempt (i.e. 50% of such dividend is subject to tax). In order to qualify for full or partial exemption, the recipient must hold the shares for at least 3 months before and after the dividend is paid. Where this holding period is not met, the dividend received will be fully subject to tax.

(vi) Tax Losses

Tax losses can generally be carried forward for 5 accounting periods for offset against profits from all sources. There is no provision for loss carry-back. Extended loss carry-forward is available under privileges granted by the Board of Investment.

Each company's losses are dealt with separately. There is no form of group relief or consolidated filing.

(vii) Thin Capitalisation

Thai limited companies are permitted to issue only ordinary shares or preference shares. Neither category of share may be issued as redeemable. There are few restrictions on the rights that may be attached to preference shares. For example, preference shares may have diluted voting rights compared to ordinary shares.

Thailand has no thin capitalisation rules that restrict the amount of interest that can be deducted for tax purposes. Interest paid by a Thai company will usually be deductible provided the rate of interest is within the limits provided by law.

Certain debt/equity ratio may be imposed on companies that are seeking tax concessions under the Investment Promotion Act.

(viii) Other Taxes

a) Value Added Tax

Value Added Tax is levied on the import and supply of goods and services. VAT is levied at the current rate of 7% (will be 10% effective from 1 October 2002) on the total price of the goods delivered or services provided. The supply of certain goods and services, such as immovable property and educational services, is exempt from VAT. Exports of goods and services are subject to VAT of 0%.

Input VAT on purchases of goods or services related to a VAT registered business may be credited against output VAT. Surplus input VAT may be carried forward against future output VAT liabilities or refunded in cash.

b) Stamp Duty

Certain types of documents and transactions are subject to stamp duty at various rates. Among the more significant instruments subject to stamp duty are lease contracts for immovable property, share transfers, hire purchase contracts, and contracts for the hire of work.

c) Specific Business Tax

Specific Business Tax (SBT) is collected on certain types of gross revenue at fixed rates. Among the more significant types of revenue subject to SBT are interest and proceeds on transfers of land.

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profit on Sale of Shares

Capital gains derived from the sale of shares are treated as normal income and are subject to corporate income tax. The gain is calculated as the difference between the sales proceeds and the cost of investment. Gains derived by a foreign investor on the sale of shares in a Thai company are generally subject to withholding tax of 15% if the gain is paid "in or from" Thailand. However, many double taxation agreements provide exemption from tax on capital gains on the sale of shares.

b) Stamp Duty

Documents effecting the transfer of shares in a Thai company are subject to stamp duty, where such documents are executed in Thailand, or executed overseas and subsequently brought into Thailand. Stamp duty is calculated at 0.1% of the greater of the selling price, or the paid-up value, of the shares.

(ii) Buyer's Perspective

a) Acquisition Structure

Most share acquisitions are structured as direct investments from outside Thailand, except where foreign ownership restrictions necessitate the establishment of a holding vehicle in Thailand. If it is intended that the whole, or part of, the investment in the Thai target will ultimately be sold, it may be advantageous to hold the investment through a holding company located in a country which has entered into a double tax agreement with Thailand that exempts from Thai tax, gains on subsequent sale of Thai target (see section, 'Exit Route').

Recently, foreign investors have had the opportunity to invest through property or equity funds. Investment through such funds has been used both in order to take advantage of preferential tax treatment granted to such funds and as a mechanism for avoiding foreign ownership restrictions under the ABA.

b) Funding Costs

Interest on loans used to fund investments is deductible from profits subject to corporate income tax. However, as Thailand has no group relief or consolidated filing, the use of a leveraged Thai acquisition vehicle is not tax effective. In addition, as dividends received by the holding vehicle should be fully exempt from tax, the holding vehicle would have no taxable income against which to offset interest costs.

c) Preservation of Tax Losses and Tax Incentives

A change in ownership of a company does not affect the carry-forward of tax losses. A change in ownership will generally not affect the availability of tax incentives, provided there is no breach of any ownership condition imposed by the Board of Investment.

STRUCTURING AN ASSET DEAL

(i) Seller's Perspective

a) Gains Ordinarily Subject to Corporate Income Tax

A company that sells any assets, including its entire business, is liable to corporate income tax on any gain derived on the sale. The company may offset its tax losses, if any, against the gain. The gain is calculated as the difference between the proceeds received less the tax book value of the assets.

Various tax exemptions apply to a statutory merger of companies and the transfer of a company's entire business.

b) Amalgamation

Under a statutory merger of companies (an amalgamation), the merging companies are dissolved and a new company is formed. For tax purposes, the merging companies recognise no gain or loss on the transfer of assets. The new company formed through the merger continues to depreciate assets on the same basis as the original companies. However, any tax losses in the merging companies may not be transferred to the new company formed through the merger.

c) Transfer of Entire Business

Where one company transfers its entire business to another, and enters into liquidation in the same accounting period as the transfer, the transferor may treat the transfer as taking place at no gain or loss. The transferee continues to depreciate assets on the same basis as the transferor company. As with a merger, the tax losses in the transferor may not be transferred to the transferee.

d) Value Added Tax

A sale of movable assets will usually be subject to value added tax, based on the value of the assets transferred. However, provided certain conditions are met, exemption from VAT is available for:

- the transfer of an entire business; and
- a partial business transfer between companies under common ownership or control (affiliated companies);

e) Specific Business Tax

Sales of immovable property are generally subject to specific business tax of 3.3% of the gross income received (The rate may be reduced to 0.11% for sales registered prior to 31 December 2002 (currently under consideration of the Cabinet). A sale may be fully exempt from tax if immovable property forms part of an entire or partial business transfer.

(ii) Buyer's Perspective

a) Acquisition Structure

In most asset acquisitions, the buyer will form a new limited company in Thailand through which the assets would be acquired. Rarely, a foreign investor would directly acquire assets and thereby form a branch in Thailand.

In the case of acquisitions of real property assets, where foreign ownership restrictions apply, foreign investors may acquire ownership of the assets via a property fund.

b) Equity Structure

In most circumstances, the capital of a limited company will consist only of ordinary shares. Where foreign ownership restrictions require the participation of local shareholders, such shareholders may hold preference shares, carrying diluted rights.

Preference share financing may also be used where the company acquiring the assets would be unable to utilise interest deductions, for example, where it has been granted a corporate income tax holiday under investment promotion privileges. In such circumstances, the preference shares will be used as quasi-debt, with mechanisms being put in place to effectively redeem the preference shares on termination of the tax holiday.

c) Funding Cost

Interest on loans used to acquire assets is generally fully deductible in calculating profits subject to corporate income tax. One exception is where the acquired asset is not immediately brought into use in the business. In such circumstances, interest should be capitalised as part of the cost of acquiring the asset, until such time as it is brought into use. The capitalised interest may be depreciated as part of the cost of the asset.

Interest is deductible when it falls due for payment. Where the acquiring company is unable to utilise interest deductions, such as where it benefits from a tax holiday, financing may be provided using discounted notes in order to defer interest deductions. If the debt is appropriately structured the discount on the note would only be deductible upon the redemption of the note. If this takes place after the tax holiday, deduction for interest payments may be deferred until tax relief can be obtained.

d) Cost Base Step-up

Unless the transfer of assets has taken place on a tax-free basis, the buyer is entitled to depreciate assets acquired based on the acquisition price. The buyer may therefore obtain a step-up in the cost basis of the asset. The buyer will depreciate the asset as if it was acquired new. The fact that the asset has previously been depreciated would not result in a reduction in the minimum depreciation periods to the buyer.

Maximum depreciation rates are imposed by statute. The maximum rates are illustrated below.

Asset depreciation rates

Asset category	Maximum depreciation rate (%)
Durable buildings	5
Temporary buildings	100
Cost of acquisition of goodwill, patents, trademarks and other rights:	
- if period of use is not limited	10
- if period of use is limited	Period of use
Other assets	20

e) Treatment of Goodwill

Goodwill purchased as a separately identifiable asset may be capitalised for tax purposes and depreciated over a period of not less than 10 years.

f) Tax Losses and Incentives

Tax losses are not transferable on a sale of assets, even where the sale represents the transfer of an entire business. Tax incentives may be transferred at the discretion of the Board of Investment.

g) Value Added Tax

If a transfer is not otherwise exempt from VAT, then, provided it is VAT registered at the time of the transaction, the buyer should be entitled to recover any VAT paid on the acquisition of the assets. The recovery may be made either by offsetting the VAT paid against future liability to output VAT, or by claiming a cash refund.

EXIT ROUTE

Where an offshore investor is selling shares in a Thai company the investor will generally be able to avoid Thai taxation on any capital gain. If the sale is made between two offshore entities, the gain will not be paid 'in or from' Thailand, and is not subject to Thai taxation. If the exit route is a sale to a Thai resident, or via the Thai exchange, tax on the gain may be avoided either by:

- Holding the investment through a company located in a territory having a double tax agreement with Thailand that provides for exemption from Thai tax on gains from the sale of shares; or
- Stepping up the cost base of the shares via an offshore sale before the sale into Thailand so that no gain is generated on the exit sale.

If the exit is via a sale of assets the seller will be exposed both to tax on the capital gain on the sale of the assets and to withholding tax on the distribution of the profits. Tax on the gain may be avoided by putting the transferor company into liquidation in the same accounting period as that in which the transfer takes place. However, this strategy may be unacceptable to a buyer, as it deprives the buyer of any step-up in the cost basis of the assets.

ENDING REMARKS - PREPARATION FOR A DEAL

M&A transactions in Thailand involve significant legal and tax considerations for both buyer and seller. Foreign investors would be well advised to ensure that transactions are planned at the earliest stage and that adequate due diligence is performed. Buyers should also be aware that Thai sellers will often seek co-operation in mitigating the seller's tax liabilities. Where this cannot be done, the seller may seek to negotiate a higher selling price.

Foreign companies disposing of shares or assets in Thailand have a number of opportunities for mitigating or eliminating Thai taxes on the sale. Again, planning at the earliest stage will provide the best assurance that tax liabilities are minimised.

VIETNAM

Country M&A Team

Country Leader ~ Tim Finlayson
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SECTIONS

GENERAL INFORMATION

(i) Introduction

After decades of wars and a system central planning economy, Vietnam in 1986 opened up the country to external trade and introduced a 'market economy with socialism orientation' concept similar to China. The core of this 'Doi Moi' or renovation policy is the liberalisation of the production force, limitation of the government's involvement in business activities and encouragement of investment from various economic sectors and foreign investment.

With a foreign policy to build up good relationship with all other countries in the region, Vietnam has deliberately and proactively pursued a benign foreign policy with a wide range of countries. The relationship with China became normalised in 1991. Diplomatic relations between Vietnam and the United States were re-established in July 1995 and a bilateral trade agreement was signed by both countries in 2000. Vietnam also became an official Association of Southeast Asian Nations (ASEAN) member from 1995. The country concluded a cooperation agreement with the European Union. The relationship with multi-national financial institutions such as the World Bank, the International Monetary Fund and the Asian Development Bank have been re-established. Vietnam's economic access to the region and the world has been accelerated. Since 1 January 1996, Vietnam has been participating in ASEAN Free Trade Area (AFTA) and joined Asia Pacific Economic Cooperation (APEC) in 1998. Negotiations are being carried out for Vietnam to become a member of the World Trade Organisation (WTO).

On 13 July 2000, the United States and Vietnam finally signed a far-reaching trade pact after 4 years of negotiations and this became effective on 1 January 2002. As well as trade, the Bilateral Trade Agreement (BTA) covers a variety of other areas including copyright protection, transparency of laws and regulations, and investment. The BTA essentially constitutes a commitment by both countries to open their markets to each other.

(ii) Common Forms of Business Entity

Currently, the common forms of foreign investment in Vietnam are:

- joint ventures enterprises; *
- wholly foreign-owned enterprises; *
- Business Cooperation Contracts (BCC); and
- branches of foreign companies

* *Collectively known as Foreign Invested Enterprises (FIE)*

However, the Law on Foreign Investment mainly governs the three basic forms of foreign investment:

- joint venture enterprises;
- wholly foreign-owned enterprises; and
- Business Cooperation Contracts (BCC).

The investment licence is valid for a maximum duration of 50 years from the date of issue; however, for special cases with the approval of the Permanent Committee of the National Assembly, the investment licence may be extended to a 70-year term. During the term of investment in Vietnam, businesses with foreign invested capital and BCC are allowed to change their existing forms by division, separation, merging and consolidation. The conditions are regulated by the Government. Furthermore, foreign companies with on-going business relations with Vietnam may establish representative offices or branches in Vietnam.

Capital contributions may be made in cash or in kind. In order for an enterprise to be classified as a FIE, the capital contribution by foreign investors should represent at least 30% of the total investment. FIE are also required to observe the 70/30 debt/equity ratio stipulated in the investment regulations.

(iii) State-Owned Enterprise Reform

Vietnam, in its efforts to integrate into the global economy, has begun to implement State-Owned Enterprises (SOE) reform by allowing selected SOE to become Joint-Stock (i.e. shareholding) Companies (JSC) through a process known as equitisation. Currently, there are approximately 800 small-and-medium sized SOE out of a total of 5,600 SOE that have converted to this company structure. Since the number of equitised SOE is small, the government intends to accelerate the process between years 2002 and 2005, which will include the equitisation of some of the more significant SOE. This presents an opportunity for foreign investment to invest in large ‘blue-chip’ companies in Vietnam.

Under the current regulations, foreign buyers may hold a maximum of 30% of the total number of shares issued but requires approval from the Prime Minister’s office for which precedent has been set.

(iv) Joint Stock Company

The concept of equitisation also applies to private limited liability companies which are not SOE. The same foreign ownership restrictions as mentioned above apply to JSC as well. This also represents an opportunity for foreign investors to invest in local companies.

(v) Vietnam Stock Market

Vietnam recently established a stock market with 12 listed companies. Those SOE and private limited liability companies that have equitised into JSC are eligible for listing on the Stock Trading Centre once they have met the requirements of the State Securities Commission.

Under the current regulations, foreign buyers may not hold more than 7% (in respect of a foreign organisation buyer) or 3% (in respect of a foreign individual buyer) of the total number of shares issued by any of these listed companies. Total foreign ownership in a listed entity is restricted to a maximum of 20%.

(vi) Foreign Ownership Restrictions

Permitted foreign investment projects are classified into the 'Encouraged', 'Permitted' and 'Prohibited' categories. Currently, foreign investments are still being carried out on a project by project basis with specific licence/approval required to be obtained from the relevant authorities. Foreign investors should therefore enquire as to the appropriate categories of their investments and the approval process before embarking on a merger and acquisition deal in Vietnam.

(vii) Tax Rates

a) Business Income Tax (BIT)

Under the current Vietnam BIT regulation, foreign invested companies and foreign parties to BCC are subject to the tax rates imposed under the Law on Foreign Investment. The standard rate of tax is 25%. Domestic enterprises, branches of foreign companies and foreign contractors not subject to the Law on Foreign Investment are taxed at a standard rate of 32% on their profits.

In order to encourage foreign investment, Vietnam offers various preferential tax treatments to FIE in encouraged regions and industries.

- In the form of income tax holiday

  Joint ventures, wholly foreign-owned companies, foreign parties to business co-operation contracts and domestic enterprises may be eligible for tax holidays. The tax holidays take the form of complete exemption from BIT for a certain period beginning immediately after the enterprise achieves profit, followed by a period where tax is charged at half the applicable rate. The duration of these holiday periods correlates directly with the BIT rate applicable to the project, and may continue for up to 8 years.

- In the form of reduced tax rate

  Preferential rates of 10%, 15% and 20% are available where certain criteria is met and in industrial sectors or locations in which investment is encouraged. Preferential rates are available for a period of between 10 years and the duration of the project, starting from the commencement of operating activities. When the preferential rate expires, the rate generally reverts to the standard rate.

b) Reinvestment

If profits are reinvested in the business or a new project in Vietnam for at least three consecutive years, a portion or all of the tax paid on the profits may be refunded when certain specific conditions are met.

c) Withholding Tax

Withholding taxes may apply to payments of dividends, interest, royalties, licence fees, foreign contractors' fee, and cross border lease charges. Each of these areas is examined separately below. Provisions of double tax agreements which Vietnam has concluded with a number of other countries may apply to exempt or reduce these withholding tax liabilities.

Dividends - General Rules

On remittance of profits abroad by a foreign investor, a remittance tax is deducted, as follows:

Legal capital contributed by foreign investor	Rate (%)
US$10m and over	3
Between US$5m and US$10m	5
Less than US$5m	7

Payments to a foreign parent used by the parent to fund the expenses of a representative office in Vietnam constitute a transfer of funds abroad and are therefore subject to profits remittance tax.

Dividends - Exceptions

Vietnamese residing abroad making investment in Vietnam and foreign investors investing in Export Processing Zones/Industrial Parks/High-Tech Zones or in areas where conditions are specially difficult are entitled to a remittance tax rate of 3%, regardless of the size of legal capital contribution.

Interest

An interest withholding tax of 10% was introduced and applies to any loan agreements signed after 31 December 1998. However, offshore loans provided by certain Government or semi-Government institutions may obtain an exemption from the interest withholding tax by specific concession agreed with Vietnam.

Royalties

A 10% royalty withholding tax applies in the case of payments made to a foreign party for transfers of technology, unless the transfer is contributed as part of legal capital. Transfer of technology is defined very broadly. Contracts for the transfer of technology are required to be registered with the Ministry of Science, Technology and Environment.

Payments to Foreign Contractors

A withholding tax on payments to foreign contractors applies where a Vietnamese contracting party (including a foreign-invested enterprise licensed under the Law on Foreign Investment) contracts with a foreign party who does not have a licensed investment in Vietnam to purchase goods and services.

Cross-Border Leases

A Vietnam-based lessee is required to withhold tax from lease rental payments to an offshore lessor. The withholding tax rate, comprising a deemed BIT rate of 5% and Value Added Tax (VAT) of 5%, applies to all lease rental payments, regardless of the date of the lease contract. Certain specific lease operational expenses may be deducted from gross revenue in order to calculate taxable turnover. Cross-border leases of drilling rigs, aeroplanes, and ships, of a type not available from Vietnamese production, are exempt from VAT. The VAT withheld by the lessee constitutes an allowable input credit in its VAT returns to the extent the lessee makes VATable supplies.

(viii) Tax Losses

Joint ventures, wholly-owned foreign enterprises, foreign parties to BCC and branches of foreign companies and domestic enterprises may carry forward their losses for 5 years. Carry-back of losses is not permitted. There is no provision for any form of consolidated filing or group loss relief.

(ix) Thin Capitalisation

As indicated above, a FIE is required to observe 70/30 the debt/equity ratio stipulated in the investment regulations. In rare circumstance where specific approval is obtained, a higher debt/equity ratio may apply.

(x) Other Taxes

Apart from income tax, FIE are subject to various other taxes in Vietnam as summarised below.

Tax	Tax rate	Scope of charge
VAT	0%, 5%, 10% and 20%. In addition, VAT exemption are applicable to a number of goods and services	Sale and importation of goods and provision of services
Special Sales Tax	15%-100%	Manufacturing and importation of a specific number of goods and provision of specific services.
Land Rental	Maximum US$12/sq m/year	

STRUCTURING A SHARE DEAL

(i) Seller's Perspective

a) Profit on Sale of Equity Interest

Vietnam has a Capital Assignment Profit Tax (CAPT) which operates within the Business Income Tax provisions that would apply to the transfer of shares of foreign investors in a Vietnam entity. Accordingly, a foreign investor transferring its shares in a Vietnam subsidiary would be subject to CAPT at 25% on the gain derived from the transfer.

Taxable profits for the purpose of CAPT are determined as the excess of the transfer value less initial value of the assigned capital (i.e. acquisition/investment cost) less transfer expenses which are directly related to the transfer. Transfer value is determined based on the actual transfer price according to the transfer contract. However, the tax authorities have the right to impute a deemed fair market value if there is no contract price available or the price stated in the contract is viewed by the tax authorities as not being at arm's length.

However, if the seller is a tax resident of a country that has entered into a double tax treaty with Vietnam (e.g. Singapore), which provides exemption from Vietnamese tax on such capital gains, the gain would not be subject to any Vietnamese tax unless the assets of the target company consist principally of immovable property situated in Vietnam.

The buyer is responsible for withholding the CAPT from payment to the transferor and paying such CAPT to the State Budget.

After payment of CAPT as stipulated above, a profit remittance tax (PRT) would be imposed on the amount of net profit which is remitted overseas or retained overseas. The applicable PRT rates are as follows:

- 3% if the amount of legal capital (i.e. equity) contribution is US$10 million or more; or if the foreign investor invests in Industrial Zones, Export Processing Zones, High Technology Zones, in areas with especially difficult socio-economic conditions where investments are encouraged.

- 5% if the amount of legal capital contribution is from US$5m to less than US$10m, or for projects engaged in medical services, education and training, services and scientific research services.
- 7% if the amount of legal capital contribution is below US$5m.

Initially, PRT applied on physical remittance of profits by foreign investors. However, the Ministry of Finance has extended the scope of PRT to cover the payment occurring outside Vietnam or is used in Vietnam by foreign investors for other purposes such as financing the representative office in Vietnam, repayment of loans/lending or purchase of goods for the parent company. Accordingly, the capital gain on transfer would also be subject to PRT.

(ii) Buyer's Perspective

a) Acquisition Structure

Under a typical share deal model, a buyer would use an offshore investment holding vehicle to acquire the Vietnamese target company. This is largely due to the fact that foreign companies may not establish special purpose holding companies in Vietnam.

b) Preservation of Tax Losses and Tax Concessions

Where a target company has accumulated losses carried forward and the buyer wishes to preserve the losses, it will have to acquire the business via a share deal as there are no provisions to transfer losses from one entity to another.

If a target company has been granted a tax concession, the buyer will have to acquire the capital of the company if it wishes to preserve the concession.

c) Funding Cost

The cost of funds used to acquire the equity interest is not tax-deductible. Accordingly, a buyer may need to structure the acquisition in such a way that the cost of funds may be tax-deductible in another country.

d) Acquisition Expenses

Currently, Vietnam does not have stamp duty nor VAT that applies to the transfer, sale and assignment of shares in a foreign invested enterprise.

Acquisition expenses incurred by the buyer may not be allocated to the target company and therefore may not be claimed as a tax deduction in Vietnam.

STRUCTURING AN ASSET DEAL

A typical asset deal model involves the formation of a new FIE or the use of an existing FIE to acquire the selected assets, liabilities and commercial operations of the target business.

(i) Seller's Perspective

Any gain or loss derived from the sale of tangible and intangible assets is normally taxable/deductible for Vietnamese business income tax purposes.

Transfer of assets within Vietnam also attracts Vietnamese VAT including disposal of used equipment. The disposal of duty-free imported equipment would result in claw back of the customs duty and VAT exemption benefits granted upon importation of the equipment concerned based on a pro-ration formula.

In Vietnam, the asset deal model is commonly used when a partner injects its business into the joint venture and foreign investors may prefer to form a new FIE to take over the business operations so as to minimise their exposures to any inherent tax and business risks, and hidden or contingent liability, that may be associated with the target company.

(ii) Buyer's Perspective

Buyers are liable for stamp duty on the total contract sum of the property transfer agreement. The applicable rate is 1% in respect of buildings, land and boats/ships, and 2% for other certain assets (e.g. motor vehicles etc). However, the duty is capped at VND 500m per asset per transaction.

EXIT ROUTE

(i) Profit Repatriation

Foreign investors may repatriate profits from FIE in the form of dividends. In particular, foreign investors are allowed to make payment of interim dividends based on semi-annual or quarterly business result, but limited to 70% of the total distributable profits.

There is currently no clear definition of distributable profits in any relevant legal documents. Verbal confirmation with the authorities and practice to date suggests that the distributable profits are determined on the basis of accounting profits, adjusted for actual tax payable less any contributions to legal reserves and compulsory funds. However, under the current Foreign Investment Law (issued in 2000), there is no longer any requirement for setting up of a legal reserve and other compulsory funds for BCC or for FIE.

(ii) Exit Route

Under the Foreign Investment Law of Vietnam and its implementing regulations, foreign investors in Vietnam have the right to repatriate:

- profits derived from the business activities;
- proceeds from provision of technology and services;
- repayment of principal and interest on foreign loan during the operation;
- investment capital; and
- other money and assets, which are legally owned by foreign investors.

Profits may be repatriated after the fiscal year has been completed, and tax obligations fulfilled.

The investment capital of foreign parties to BCC may be repatriated by the end of the project (i.e. after liquidation) or during the project life in the form of repatriation of cash from depreciation fund.

Cash may also be repatriated in the form of management fees, consultancy fees, royalties and other overseas expenses.

ENDING REMARKS - PREPARATION FOR A DEAL

(i) Seller's Perspective

Disposition of investments in Vietnam involves complicated regulatory, legal and tax considerations. Approvals from the Vietnamese licensing body and relevant authorities are required for any change of shareholdings in FIE.

Depending on the investment objectives and exit strategies, the seller should consider the need to reorganise the underlying target companies in order to facilitate the disposition as tax-efficient as possible.

Furthermore, the seller needs to assess the income tax and other transactional tax costs that may arise in the disposition. Planning and tax-efficient structuring can often be achieved prior to entering into a deal with the result that Vietnam transactional tax costs would be reduced.

(ii) Buyer's Perspective

The adoption of an asset deal or a capital deal for an acquisition in Vietnam largely depends on the specific regulatory situations, as well as the commercial and tax objectives of the investors. Under an asset or capital deal, tax planning is essential in maximising the tax opportunities arising from such an acquisition as well as to manage the tax downsides and exposures associated with the merger and acquisition transactions.

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