Foreword

It is a great pleasure to present you with Issue No. 17 of our Asia Pacific Tax Notes.

The economies in Asia are starting to show signs of an upturn, and there is increasing interest by companies actively looking for good investment opportunities in the region.

This issue begins with a very topical lead article on recent developments in the Avoidance of Double Tax Agreements (DTA) in the region written by Christian Pellone. As readers are aware, the main purpose of DTAs is to prevent and eliminate international double taxation on cross border transactions. This will facilitate and encourage capital and investment flows into the region. This article looks at the features of some of the recently signed or re-negotiated DTAs, such as the Hong Kong / Belgium DTA, and the Japan / US DTA.

We also have the usual round up of tax developments in the region. This focuses mainly on recent budgetary developments, and measures and incentives intended to encourage investment and stimulate economic activities in the respective countries in the region. I would like to remind readers to check with their local PricewaterhouseCoopers (PwC) contacts on the progress in giving statutory effect to the budgetary proposals.

Asia Pacific Tax Notes is also available in pdf format. If you require an electronic copy, please contact our editor Raymond Wong at raymond.wong@hk.pwc.com, or his assistant editor Gloria Chan at gloria.lk.chan@hk.pwc.com.

I would finally like to thank the editorial team in Hong Kong and all the PwC Offices in the region for their contributions to Asia Pacific Tax Notes. This publication would not be possible without them.

Rod Houng-Lee
Asian Tax Leader

Editor’s Note

This publication is designed to alert those interested in or already doing business in the Asia Pacific region to recent tax developments in the region. Such developments are discussed in brief and general terms, and therefore the material contained herein should not be regarded as a substitute for appropriate detailed professional advice. Material in this issue generally covers developments up to March 2004, unless otherwise indicated.
There have been several notable double tax agreement (DTA) developments in the region in recent months. These developments have caused tax practitioners to re-consider established tax planning for regional investments.

New treaties have been signed – eg. Hong Kong-Belgium DTA – which potentially provide ‘best practice’ holding structures in terms of repatriation and exit planning.

European countries such as Cyprus and Malta are increasingly being used in regional structures due to their wide treaty networks and favourable domestic tax regimes.

There have been some negative DTA interpretation items – eg. Labuan not being respected as part of Malaysia for DTA purposes in various countries; and positive items as well – eg. India confirming it respects Mauritius holding structures.

This article discusses the key DTA related developments in the region, with a focus on the impact to regional tax planning.

Hong Kong – Belgium

Hong Kong concluded its first comprehensive DTA with Belgium. It will apply with effect from 1 January 2004 in Belgium and 1 April 2004 in Hong Kong (HK). It is a full scope DTA based on the OECD model convention. It has been ratified in HK but not yet in Belgium, although this is expected to occur with retrospective effect. The combination of HK’s Nil tax on offshore profits, no withholding tax on dividends and interest, and Belgium’s favourable participation concessions offers various planning possibilities. From an international tax planning perspective, the two most interesting components of this DTA are:

1. Nil withholding tax on dividends if more than 25% is held for at least 12 months, and
2. No limitation of benefits clause.

This means HK-Belgium is now a strong inbound investment structure [Fig. 1] for many regional targets because:

a) Belgium’s DTAs typically allocate taxing rights on the disposal of target shares to Belgium (eg. DTA with Australia). But Belgium does not tax gains from the disposal of participating shareholdings.

b) Belgium has concessional tax on dividends received from target - 5% taxed at normal rates, effective rate 2%.

c) No withholding tax on dividends from Belgium to HK. This means sale proceeds on exit can be repatriated tax free to the Buyer without having to liquidate Belgium or interpose another country like Luxembourg.

d) Dividends received by HK are tax free and can be passed out anywhere in the world without withholding tax, and

e) HK is a simple jurisdiction, companies are easy to set up and cheap to administer, and the infrastructure is good.
HK-Belgium is likely to be a popular alternative to the common Luxembourg-Netherlands holding structure, which has withholding tax issues to manage (for payments outside the EU) and can be expensive to set up and maintain.

Given that Netherlands does not tax dividends or profits from the disposal of participating shareholdings, the Netherlands is now an ideal jurisdiction for investing into Indonesia. Dividend withholding tax from the Netherlands still needs to be managed (usually occurs by interposing a Luxembourg holding company).

A unique exemption for interest withholding tax is also available in the new DTA on qualifying loans, potentially allowing a cheaper profit repatriation route to dividends.

**Indonesia – Mauritius**

The Indonesian government has sent a notice to the Mauritius government requesting a broad renegotiation of their DTA. This may result in the DTA being terminated, but this is not expected according to the Indonesian tax office. Unfortunately there are no public details of the intended changes.

This should be closely monitored because Mauritius is a common jurisdiction for investing into Indonesia (no capital gains tax on exit plus concessionary withholding tax rates).

**Japan – USA**

Japan has recently signed a new DTA with the USA, replacing the existing treaty which has been in place for more than 30 years. The new DTA should apply from 1 January 2005 once it has been ratified.

The new DTA has significantly lower withholding tax rates than its predecessor - 0% on dividends for more than 50% participations and pension funds (down from 10% and 20% respectively), 0% on royalties (down from 10%), and 0% on interest for banks and pension funds (down from 10%).

However, these lower rates are not automatic and must pass new and stringent anti-avoidance provisions, such as a detailed limitation on benefits article, introduced for the first time into Japanese tax treaties.

**Indonesia – Netherlands**

Indonesia has signed a new DTA with the Netherlands. The new treaty provides beneficial withholding tax rates for dividends (10%), but also allocates taxing rights on the disposal of shares to the holding jurisdiction.

**Mauritius – India**

It is estimated that 60% of foreign investment in India over the past 10 years has been routed through companies registered in Mauritius to take advantage of favourable DTA tax advantages - ie. capital gains arising from the sale of Indian shares are tax free, and dividends are concessionally taxed at 5% or 15% depending on the level of shareholding. We note that India abolished dividend withholding tax from June 1997, so companies now use holding companies in Mauritius principally for capital gains tax protection.

The Indian government attempted to challenge these structures using treaty shopping arguments, particularly where the Mauritius holding company was a mere shell.

However, the Supreme Court of India has now confirmed that residence certificates issued by Mauritius, even for shell companies, are valid for the purposes of applying the Mauritius-India DTA. The treaty must be respected by the Indian tax authority.

This was a major win for taxpayers, and means Mauritius continues to be a good jurisdiction for investment into India.
**PRC – Macau**

A new DTA has been signed between Mainland China and Macau. However, there are unlikely to be any immediate structuring advantages for MNCs investing into China for several reasons:

- China continues to apply capital gains tax on share disposals where the participating holding is more than 25%. For less than 25% interests, Macau will apply income tax at 15%. A number of China’s other DTAs, including that with Mauritius, provides for 0% tax on disposals of PRC entities.

- The Nil tax regime in Macau (Macau Offshore Centres, or MOCs) will not be able to access treaty benefits, because MOCs are not regarded as residents of Macau for tax treaty purposes. This means MOCs with operations in China cannot rely on PE protection. In addition, it is unclear whether MOCs can hold shares in China companies.

This DTA should, however, act to apply pressure to the Hong Kong government to upgrade the existing tax arrangement with China, because Hong Kong and Macau are competitors for regional business. China has been believed to be chasing a DTA with Hong Kong for some time, but until now, Hong Kong has been delaying.

**Labuan**

Labuan is a federal territory of Malaysia with its own concessional tax regime. Historically, many companies established Labuan holding vehicles for their offshore investments, and sought to rely on the Malaysian DTA for treaty concessions.

Various countries have now confirmed that they will not respect Labuan as part of Malaysia for DTA interpretation purposes.

Since 1996, the UK, Netherlands, Japan and Australia have exchanged notes with Malaysia to exclude Labuan from the scope of their DTAs.

In late 2002, Korea commenced negotiations with Malaysia to also exclude Labuan from its treaty, but the outcome of these negotiations has not been finalised. PwC Korea believes this is imminent.

More recently, new Swedish and Luxembourg DTAs with Malaysia specifically exclude Labuan. This has been an increasing trend in recent years, and other countries are expected to follow.

Although Labuan is increasingly being excluded from DTA concessions, tax concessions for transactions between Labuan and Malaysia have not changed. This means that a Labuan-Malaysia-Target structure may be a suitable alternative to a simple Labuan - Target structure, especially since including Labuan mitigates central bank control and exchange issues usually associated with setting up structures in Malaysia.

For example, Fig. 2 shows a Labuan-Malaysia-Korea structure. Dividends from Korea are not taxable in Malaysia and can be passed out with no withholding tax or imputation tax. Capital gains on the disposal of Korea are tax free in both Malaysia and Korea. Resulting profits can be passed to Buyer via a liquidation of Malaysia with no withholding tax or imputation tax in Malaysia, and only a small amount of tax in Labuan (RM20,000 fixed).

![Fig.2 Labuan/Malaysia](image-url)
Cyprus
An increasingly popular holding jurisdiction for regional investments is Cyprus. Cyprus has a wide treaty network and a concessional tax regime. The main tax features are:

- There is no tax on the disposal of securities
- Exemption system on foreign sourced dividends
- No thin capitalisation rules
- No withholding tax on payments

These strong tax concessions and various DTAs facilitate a single tier investment structure into regional countries. Cyprus also has the advantage of already being accepted into the EU with effect from 1 May 2004. Its reformed tax system is thought to be in full compliance with the EU and OECD requirements for anti competitive tax behaviour.

Malta
We are also increasingly seeing the use of a single tier Malta holding company for regional investments. Malta has a somewhat unique tax regime which essentially allows for 0% capital gains tax and 0% tax on dividends received and on-paid to foreign shareholders.

This occurs partially by way of direct exemption (eg. no dividend withholding tax in domestic law), and partially by way of a refund mechanism where 100% of tax otherwise payable in Malta is refunded upon payment of profits outside of Malta. Given that Malta has negotiated over 30 DTAs (more than Cyprus) and is not a high cost jurisdiction in terms of set up and maintenance, this is becoming a popular holding company jurisdiction.

Malta has also recently been accepted into the EU with effect from 1 May 2004, which means they, like Cyprus, have satisfied the EU in relation to anti competitive tax policies.

A key issue with using a Maltese holding company is that tax concessions do not apply to shareholdings which are ‘trading stock’, which are investments held principally for resale. This needs to be managed if a short-medium term sell down is intended.

Conclusion
Astute MNCs are changing the way they structure into the region as a consequence of various DTA developments, and are realising material commercial and tax benefits as a result.

Established tax structures should be revisited to determine whether there is a more effective structure available to suit a particular investment.

Further DTA developments should be closely monitored to make sure new structuring opportunities are being fully exploited.
INTRODUCTION

The last 12 months have represented another huge year in Australian tax with the introduction of the new Taxation of Foreign Arrangements rules along with a raft of other tax developments. More changes are set to come in the following 12 months as the Government introduces some of the Review of International Taxation Arrangements alluded to in earlier editions of Asia Pacific Tax Notes.

The key changes introduced since the last edition of Asia Pacific Tax Notes and significant developments on the horizon for the rest of 2004 are outlined below.

TAXATION OF FINANCIAL ARRANGEMENTS (TOFA)

On 17 December 2003 Australia introduced a set of rules that aim to clarify the taxation treatment of foreign currency gains and losses.

What do the new rules do?

The central feature of the new regime is the introduction of a core framework that provides certainty regarding the timing of recognition of currency gains and / or losses and also ensures that those amounts are recognised consistently for tax purposes. The new measures also set out rules for translating amounts of foreign currency to Australian dollars for Australian tax purposes.

Who are affected by the new rules?

The new regime impacts on all Australian taxpayers who:

- hold bank accounts denominated in a foreign currency;
- have loans denominated in a foreign currency;
- undertake other foreign currency denominated transactions including the sale or purchase of assets; or
- receive remuneration, derive income or incur expenditure in a foreign currency.

How the new rules work?

The legislation operates on the basis that foreign exchange gains are assessable income, and foreign exchange losses are allowable deductions, rather than subject to capital gains tax treatment (subject to specific exclusions). Currency gains or losses are categorised into various “forex realisation events”.

Under the new regime all foreign exchange gains or losses are recognised for tax purposes at the time of a forex realisation event. The five main forex realisation events arise where an entity:

1. disposes of foreign currency or a right to receive foreign currency;
2. ceases to have a right to receive foreign currency (for example, a right to receive USD is discharged by receipt);
3. ceases to have an obligation to receive foreign currency (for example, an entity enters into a forward contract to purchase USD which is later discharged);
4. ceases to have a liability to pay an amount of foreign currency (for example, where an obligation to pay in USD is discharged by payment); or
5. ceases to have a right to pay foreign currency (for example, where the entity exercises a right to pay USD or allows the right to lapse).
Functional currency rules
As a compliance cost saving measure, a functional currency exception to the above conversion rules has been included for certain entities which conduct business in a currency other than Australian dollars. For example, an Australian multi-national company with operations throughout Asia is able to convert its various foreign currency amounts to its functional currency, say Singapore dollars, and then convert from Singapore dollars to Australian dollars for tax purposes.

When do the new rules apply?
The new provisions dealing with foreign currency gains and losses apply to transactions entered into in or after the first income year commencing on or after 1 July 2003. In addition, taxpayers can elect to have transactions conducted prior to this time fall within the new foreign exchange rules as from the commencement date.

Australia-United Kingdom Tax Treaty
The much anticipated Australia-United Kingdom tax treaty substantially reduces the rate of withholding tax imposed on certain dividend, interest and royalty payments between Australia and the United Kingdom. It is anticipated that the reduced withholding tax rates will provide long term benefits for Australian entities doing business with the United Kingdom.

The new treaty and associated exchange of notes also contain:
- a revised list of taxes covered;
- a clause within the residence Article to deem dual listed companies to be resident only in the country of incorporation (provided that they have their primary stock exchange listing in the same country);
- a new fringe benefits Article ensuring fringe benefits are taxable only in the country with the sole or primary taxing right over that benefit where it is paid as ordinary employment income;
- a clause specifically addressing the treatment of benefits arising from certain employee share option plans granted in respect of employment partly or wholly exercised in the other country;
- comprehensive provisions on the alienation of property, including a default provision for capital gains not otherwise dealt with; and
- a new non-discrimination Article to protect taxpayers from tax discrimination in the treaty partner country and to give them rights of appeal against such discrimination.

The new treaty will have effect in Australia and the United Kingdom in relation to dividend, interest and royalty withholding taxes in both countries from 1 July 2004. The dates of effect for Australian fringe benefits tax and income taxes are 1 April and 1 July 2004 respectively.

Australia-Russia Tax Treaty
The new Australia-Russia tax treaty paves the way for an expanded economic relationship between the two countries by reducing the potential for double taxation in both countries.

The possibility of double taxation of capital gains is reduced under the treaty by the inclusion of an Alienation of Property Article, which also includes a provision that deals with the indirect alienation of real property.
The new Australia-Russia tax treaty will take effect in Australia for all Australian taxes covered by the treaty, in relation to income or profits of years beginning on or after 1 July 2004. In the case of Russia, the treaty will have effect for taxable years and periods beginning on or after 1 January 2004.

REVIEW OF INTERNATIONAL TAXATION

In the Federal Budget handed down on 13 May 2003, the Australian Treasurer announced the Government’s response to the Review of International Taxation Arrangements (RITA) conducted by the Board of Taxation. The response includes a package of reforms designed to reduce the costs of complying with the controlled foreign company (CFC) and Foreign Investment Fund (FIF) regimes, reducing tax on foreign active business income and a program of modernising Australia’s tax treaties.

The first tranche of draft legislation, which was introduced into Parliament on 4 December 2003, seeks to:

- eliminate the attribution of most of the income of a CFC in a broad exemption listed (BEL) country;
- increase the balanced portfolio FIF exemption for all taxpayers from 5% to 10%;
- exempt complying superannuation funds from the FIF rules;
- stop the FIF rules from applying to “management of funds”; and
- exempt Australian public unit trusts from interest withholding tax on interest paid on widely distributed debentures issued to non-residents.

Whilst the draft legislation is currently being considered in detail by Parliament and the Senate Economics Legislation Committee, the FIF measures are expected to apply from 1 July 2003 and the CFC measures from 1 July 2004.

The second tranche of draft RITA legislation was introduced into Parliament on 1 April 2004. If enacted, these measures will eliminate many barriers that exist for Australian companies seeking to invest offshore, both in terms of potential tax savings and simplification from a tax compliance perspective. In particular, this Bill seeks to:

- exclude from the CGT regime the sale by Australian companies and CFCs of non-portfolio interests in foreign companies with underlying active businesses;
- extend the company tax exemption for foreign non-portfolio dividends and certain branch profits to all countries; and
- modify the tainted services income definition to exclude certain income from the provision of services to non-resident associates.

The changes to the CGT rules are proposed to apply in relation to specified CGT events happening from 1 April 2004. The extension of the company tax exemption for non-portfolio dividends is proposed to apply to dividends paid after 30 June 2004, whilst the broadening of the branch profits exemption is proposed to apply to income years commencing after 30 June 2004. The modification of the tainted services income definition is set to apply in relation to statutory accounting periods beginning from 1 July 2004.

It is anticipated that the remaining RITA proposals will be implemented in the forthcoming third and final tranches of legislation.

TAXATION TREATMENT OF REDEEMABLE PREFERENCE SHARES

On 4 December 2003, the Australian Treasurer announced that the Government would introduce a regulation under the Income Tax Assessment Act 1997 to clarify the basis under which a redeemable preference share may qualify as a debt interest for the purposes of the income tax law.

Under the debt / equity provisions of Australia’s income tax law, returns on debt interests may be deductible for tax purposes but are not frankable (i.e. a tax credit is not available in respect of the underlying tax paid by the entity paying the return). This is in contrast to returns on equity interests, which may be frankable but are not deductible for tax purposes.

In broad terms, a condition for an instrument to qualify as a debt interest is that there is an “effectively non-contingent obligation” of the issuer to provide an amount that is at least equal to the amount that has been received.
Under the Corporations Act 2001 (and relevant corporations law in some foreign jurisdictions), a redemption or buy-back of shares may only be undertaken if it does not prejudice the company’s ability to pay its creditors. The objective of the regulation will be to ensure that this type of legislative condition will not be a contingency for the purposes of the debt / equity rules and therefore will not preclude a redeemable preference share from being classified as a debt interest.

It will be important to review the taxation treatment adopted for redeemable preference shares issued since 1 July 2001, and to ascertain whether such interests have been treated as equity interests on the basis of the Corporations Act 2001 contingency requirements. These interests may potentially be treated as debt interests as a result of the announced amendment.

At this stage the Government is yet to release the regulation, however it will have effect from 1 July 2001.

**TAX CONSOLIDATION UPDATE**

As reported in previous editions of Asia Pacific Tax Notes, Australia recently introduced a tax consolidation regime, which became effective from 1 July 2002. Under this regime, groups of wholly owned Australian companies can elect to consolidate for tax purposes so that they are treated as a single entity for Australian tax purposes.

Broadly, as part of the introduction of the tax consolidation regime, the group tax relief rules that applied prior to the introduction of the consolidation regime no longer apply from 1 July 2003 (except in the case of substituted accounting period (SAP) groups that elect to consolidate, or form a multiple entry consolidated (MEC) group (i.e. certain groups owned by a foreign head company with multiple entry points into Australia), as from the start of the head company’s first SAP income year after 1 July 2003).

Most importantly, the group relief rules that have been repealed (or have limited application) are:

- Capital Gains Tax (CGT) roll-overs;
- loss transfers; and
- inter-corporate dividend rebates.

However group relief is still available in certain instances for:

- CGT roll-overs between non-resident companies, or between a non-resident company and a member of a consolidated group or MEC group (or a resident company that is not a member of a consolidated group); and
- a loss transfer involving an Australian branch of a foreign bank and either the head company of a consolidated group or a MEC group formed of resident wholly-owned subsidiaries of the foreign bank, or such a subsidiary if it is ineligible to form such a group.

The grouping rules were repealed, subject to limited exceptions, because the consolidation regime has the effect that intra-group asset transfers and the payment of intra-group dividends have no tax consequences, and tax attributes such as the entitlement to claim losses are held by the head company of the group. As such, there is no need for these rules within a consolidation regime.

For further details on the scope of the consolidation regime, please refer to earlier editions of Asia Pacific Tax Notes.
CAMBODIA

In December 2003, the Cambodia government issued various Prakas and Sub-decrees to be effective from 1 January 2004. We have summarised below some of the implementing regulations:

NEW PRAKAS ON TAX ON PROFIT

The new Prakas, which supplements the 2003 Law on Amendments to the Law on Taxation, was issued on 12 December 2003. The major changes arising from the new Prakas on Tax on Profits (ToP) are as follows:

Deductibility of Expenses

Accrued expenses which are not paid within 180 days after balance date (i.e. year end date for tax purposes) will not be deductible for tax purposes. Remuneration accruals will only be deductible if they are paid within 60 days after balance date.

Withholding Tax (WHT)

For WHT purpose, expenses shall be considered as “paid” when an item is recorded as an expense in the accounting records.

Payment of rental between real regime taxpayers (taxpayer registered with the Real Regime Tax Office of the Tax Department) will be subject to 10% WHT in addition to 10% value-added tax. The income recipient is entitled to use the WHT credit to offset against ToP liability annually.

Payment for services between real regime taxpayers is exempted from WHT.

Depreciation

All taxpayers are required to adopt new tax depreciation rates and methods as of 1 January 2004 for old and newly acquired assets. Generally, assets are divided into 4 classes and each class has a prescribed rate and depreciation method.

Certificate of Compliance

A Qualified Investment Project (QIP), being any investment project registered with the Council for the Development of Cambodia (CDC), is required to obtain a Certificate of Compliance to submit with the annual ToP return in order to continue utilising any investment incentives. This requirement is effective from 1 January 2004.

SPECIFIC TAX ON CERTAIN MERCHANDISES AND SERVICES (SPECIFIC TAX)

The rates and scope of Specific Tax on the following items have been amended from 1 January 2004:

- **Telecommunication services**: international and local telecommunication services are subject to 10% Specific Tax. Pre-1 January 2004, international and local telecommunication services were subject to 2% and 0% Specific Tax respectively.

- **Air transportation of passengers**: sales of air tickets in Cambodia for local and international transportation of passengers are subject to 10% Specific Tax on the value of the tickets. Pre-1 January 2004, Specific Tax did not apply to local sales of air tickets for local transportation of passengers; the rate for the local sales of air tickets for international transportation of passengers was 2%; and the tax base was the full fare of a one way ticket or half of the round trip ticket.

- **Local beer production**: the Specific Tax rate has increased from 20% to 30%. In addition, “ex-factory sales price recorded on invoice” has been defined to include production cost, administration cost, promotional cost and profit. The Tax Department has verbally confirmed that the increase in rate will be postponed until further notice.

CUSTOMS TARIFF FOR 2004

The Ministry of Economy and Finance has revised the customs tariff for imported items effective from 1 January 2004.
A NEW DISTRIBUTION SOLUTION IN CHINA

With the issuance of the Administration Measure for Foreign Investment in Commercial Sector (hereinafter referred to as the “New Measure”) on 16 April 2004, a different horizon will be opened to foreign investors in the distribution sector starting from 1 June 2004.

In line with the provisions of the China World Trade Organisation (WTO) agreement, the New Measure has clearly included the following as allowable services of a commercial enterprise:
1. Commission agent’s services
2. Wholesaling
3. Retailing
4. Franchising

In particular, compared with the old administration measure for commercial enterprises (hereinafter referred to as the “Old Measure”), the New Measure has extended the business scope of a commercial enterprise to cover commission agent’s services and franchising. It has defined franchising as the use of a trademark, trade name or particular business model in exchange for fees or royalties, but the operational details for franchising activities are yet to be included. Instead, it is specifically stipulated that foreign investment commercial enterprises engaged in franchising activities will be required to comply with other measures governing franchising. It is therefore expected that more new measures or regulations in this regard are forthcoming.

In general, this New Measure has brought much favourable progress. First of all, certain stringent market access pre-requisites for the distribution sector under the Old Measure such as the requirements on annual turnover and asset base of foreign investor(s) are no longer present. Furthermore, the minimum registered capital is now set to align with those requirements stipulated in the Company Law. In other words, the minimum registered capital amounts are substantially reduced. For example, the minimum registered capital requirement for a wholesaling commercial enterprise is RMB500K under the Company Law instead of RMB80M (RMB60M if in Central and Western China) under the Old Measure. Similarly, the Company Law requires only RMB300K as the minimum registered capital for a retailing commercial enterprise as compared to RMB50M (RMB30M if in Central and Western China) under the Old Measure. In short, major entry barriers are removed.

Another encouraging progress is the expansion of allowable business scope for wholesaling commercial enterprises and retailing commercial enterprises. Pursuant to the New Measure, the allowable business scope is as follows:

Wholesaling commercial enterprises
• Wholesale of merchandise
• Commission agency (excluding auction)
• Import and export of merchandise
• Other auxiliary services

Retailing commercial enterprises
• Retail of merchandise
• Importation of merchandise on its own account
• Procurement of domestic merchandise for export
• Other auxiliary services

Together with an uplift of the 30% cap on the importation of overseas merchandise, the expanded business scope may enable wholesaling commercial enterprises and retailing commercial enterprises to take up more trading functions in the imminent future.

Additionally, the removal of the cap on royalty expenses at 0.3% of annual turnover (excluding VAT) and the restriction on the maximum term for royalty arrangements of 10 years set out in the Old Measure has given foreign investors more flexibility in financing arrangement.

Despite the various favourable relaxations, the current constraints on the following specific merchandise remain:
• Books, newspapers and journals
• Pharmaceutical products
• Chemical fertilizers, pesticides and mulching films
• Processed oil and crude oil
• Motor vehicles
• Grain, vegetable oil, sugar, cotton, etc.

Regarding approval for setting up commercial enterprises, the authority basically remains in the hands of the central Ministry of Commerce (MOFCOM). Under certain conditions, the MOFCOM can delegate the approval authority to its provincial branches. Besides, it is specifically
China

stipulated that a certification from the local branch of the MOFCOM on compliance of the proposed set-up with the current city and economic development plan is required for set-up application.

Overall, the New Measure is enacted in the direction of the China WTO commitments. It has lifted a lot of market entry barriers for the distribution sector and ultimately creates a more favourable business environment for foreign investors.

Valued Added Tax (VAT)

There were a lot of major changes in the Chinese VAT regime starting from the 4th quarter of 2003. The two most significant changes as discussed below contain both good and bad news.

A. Adjustment of Export VAT Refund Rates

Since the implementation of the new VAT regime in 1994, exporters in China have been entitled to VAT refund upon exportation of their products as a means to boost the competitiveness of export products. There are tax regulations setting out the ceiling for export VAT refund by limiting the refund rates of certain goods. On 13 October 2003, the Ministry of Finance and the State Administration of Taxation (SAT) jointly issued a circular to revise the export VAT refund rates. The new export VAT refund policy has become effective on 1 January 2004. It impacts on four main types of products as follows:

1. Category with no change in the export VAT refund rate
   i. Agricultural products currently entitled to refund rates of 5% and 13%;
   ii. Industrial products processed from agricultural raw materials currently entitled to a refund rate of 13% (except those goods listed in points 3 and 4 below);
   iii. Goods currently subject to VAT at 17% and enjoying a refund rate of 13% (except those goods listed in points 3 and 4 below);
   iv. Vessels, vehicles and their major parts, numerically control machines, etc currently entitled to a refund rate of 17%.

2. Category with an increase of export VAT refund rate

Export VAT refund rate for wheat flour, maize flour, cuts of ducks or goose, etc. will be increased from 5% to 13%.

3. Category with cancellation of export VAT refund

Certain scarce natural resources and ores such as wood, pulp of wood, goat hair or skin, eel fry, rare metal ores, graphite, kerosene, diesel, lubricating oil, etc. are not entitled to any export VAT refund under the new policy. For those goods which are subject to consumption tax such as diesel, the relevant consumption tax refund policy is also terminated.

4. Category with the reduction of export VAT refund rate

Export VAT refund rates for the following types of goods will be reduced:

<table>
<thead>
<tr>
<th>Types of Goods</th>
<th>New export VAT refund rates under the new policy</th>
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<tbody>
<tr>
<td>i. Gasoline and unwrought zinc</td>
<td>11%</td>
</tr>
<tr>
<td>ii. Unwrought aluminium, yellow phosphorus, etc</td>
<td>8%</td>
</tr>
<tr>
<td>iii. Coke (of coal) and semi-coke (of coal), steatite, fluorspar, etc</td>
<td>5%</td>
</tr>
<tr>
<td>iv. For other goods not mentioned in the above point 1, 2, 3 and 4(i), (ii) and (iii), if:</td>
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<tr>
<td>- current export VAT refund rates are 17% or 15%</td>
<td>13%</td>
</tr>
<tr>
<td>- current VAT levy and refund rate are both set at 13%</td>
<td>11%</td>
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Despite the fact that this revision of export VAT refund rates involves both increase and decrease in the refund rates, the average export VAT refund rate has been reduced from 15% to 12%. As a whole, most exporters are now facing an increase in operating costs.
B. “Consumption Type” VAT for China’s Three North-eastern Provinces

On 29 January 2004, the SAT issued a circular on VAT in support of the Central Government’s drive to revive the economy of China’s three north-eastern provinces by making these provinces China’s pilot areas for shifting from the current VAT regime to a “Consumption Type” VAT regime.

The Circular stipulates that eight industrial sectors in the following three provinces in north-eastern China: namely Hei Long Jiang, Jin Lin and Liao Ning (3 NE provinces), will be able to enjoy the new VAT credit treatment to be approved by the State Council. Despite the fact that no detail is given in the Circular, it is widely speculated that it should be referring to the possible credit allowed for “Input VAT” incurred on the purchase of fixed assets against “Output VAT” on sales. Please note nevertheless if the “Input VAT” on purchase of fixed assets is much greater than the “Output VAT” on sales, the excess should be carried forward and not be refunded.

Please also note that enterprises in the 3 NE provinces which are in the following eight industrial sectors are obliged to apply to the respective in-charge State tax authorities for a certification of qualification for entitlement of the above new VAT treatment. If an enterprise fails to complete the application procedure, it may not be able to enjoy the new VAT treatment.

The eight industrial sectors are:

1. Equipment assembly (including mechanical, electrical and electronic equipment);
2. Oil and petrochemical (including oil processing, production of petrochemical materials, pharmaceutical products, synthetic fibres, rubber and plastic products);
3. Metallurgy;
4. Ship-building (including building of metallic, non-metallic ships, leisure and sporting boats, manufacturing of relevant equipment set and navigating equipment, repair and maintenance for ships and demolition of ships);
5. Automobile (including manufacturing of automobiles and spare parts and repair and maintenance for automobiles);
6. Agricultural product processing (including food and beverage production, textiles, leather / fur / feather processing, wood processing, clothing manufacturing, furniture making, papemaking, craft-work, etc., [tobacco and alcohol products are specifically excluded for this purpose]);
7. Military and defence systems; and
8. High and new technology industries (including enterprises holding certificates of high and new technology enterprises issued by the provincial science authorities and whose products are listed on the <<Catalogue of High and New Technology Products in China>>).

CUSTOMS VALUATION ISSUES

Customs issued an announcement in late 2003 and effective on 11 December 2003 to allow the deduction of interest expenses from dutiable value of imported goods, provided that certain criteria are met, including:

- Interest expenses are incurred for financing arrangement made for imported goods
- A written financing agreement is available
- Interest expenses are listed separately
At the same time, Customs issued another announcement called the “Announcement Concerning Customs Valuation on Carrier Media Bearing Software for Data Processing Equipment”, effective on 11 December 2003. By virtue of this announcement, the cost or value of the software shall be excluded from the customs value where:

- The cost or value of the software has been listed separately from that of the carrier media; or
- Importers can provide proving documents to show the cost or value of the carrier media or software when the cost or value of the carrier media or software has not been listed separately.

The Announcement further defines that carrier media refers to the commodities listed under HS tariff heading 85.24, and software does not include photos, audio, video films, games etc.

This Announcement is welcomed. However, it still cannot help clarify how Customs will treat royalty payments for the software.

Such a valuation question has become particularly important after the Royalty Rule was issued in mid 2003 and effective on 1 July 2003 to cover the treatment of royalties, licence fees and similar payments relating to imported goods.

The Royalty Rule throws a very wide net over royalty payments, rendering virtually all such payments liable to customs duty (and import VAT). In some cases, it appears to go outside what is allowable under the WTO Valuation Agreement, which China adopted from 1 January 2002. The Rule also gives extensive powers to Customs, including allowing them the sole right to determine whether a royalty is caught or not by the Rule, and requiring their pre-approval to exclude the only listed exceptions to the Rule.

Anyone importing, or contemplating importing goods into China where a royalty payment is involved, is strongly advised to check the Rule against the terms of their agreements even where they believe the payment is currently not liable to customs duty.

In line with WTO requirements, the Rule is expressed so as to only cover royalty payments which are:

- related to the imported goods
- a prerequisite for the seller to export the goods to China

However, sections of the Rule which may be a concern to importers include:

- defining a royalty fee to include not only payment for patents, trademarks and copyright, but also distribution and resale rights, and “other similar payment” (which are not defined);
- prescribing in detail, and at length, when a payment must be regarded as related to imported goods;
- including royalty payments made where relevant software and other intellectual property are downloaded by satellite or via the internet;
- including imported goods subject to further processing in China under the distribution, resale, and similar rights heading;
- apparent dilution or reversal of the WTO provision where goods which have been further processed with domestic goods should only have the royalty added if it can be readily quantified in relation to the imported portion;
- the requirement by a consignee of imported goods to declare to Customs ANY royalty payments; and
- exclusion or deduction of royalty payments from the customs value can only be made after Customs approval.

The Rule retains the exclusion of royalties paid for the right to duplicate imported goods in China, but only if those royalties are listed separately (presumably, this means separately on the commercial invoice, or not shown on the commercial invoice at all); and can be quantified; and approval has been received from Customs. This section also contains, somewhat surprisingly, a reference and exclusion for fees for technical training.

In our experience, China Customs has already targeted royalty payments as an area requiring their close attention. Armed with the Rule, it is likely that individual Customs offices and officials will take an expansive view of this very broad new provisions, to capture and impose customs duty on these payments.
CLOSER ECONOMIC PARTNERSHIP AGREEMENT BETWEEN HONG KONG AND THE MAINLAND CHINA

The governments of the People's Republic of China (the Mainland) and the Hong Kong Special Administrative Region (SAR) signed the Closer Economic Partnership Arrangement (CEPA) on 29 June 2003 in Hong Kong. Similar CEPA was also signed between the Mainland government and the Macau SAR government on 17 October 2003. As these 2 CEPAs are quite similar, we are only focusing on the Hong Kong CEPA for discussion purpose.

CEPA covers three broad areas, namely the sale of goods, the provision of services, as well as trade and investment facilitation crossing the border.

On the Sales of Goods

The Mainland has agreed to apply zero import tariffs from 1 January 2004 for exports with Hong Kong as the Country of Origin for 273 categories (subsequently, changed to 374 categories due to reclassification of tariff codes) of products. The Mainland has also agreed to apply zero import tariffs by 1 January 2006, the latest, upon applications by local manufacturers for other codes maintained on the China's tariff system and meeting the CEPA Country of Origin rules. Hong Kong will undertake to continue applying zero tariff rates on all goods of Mainland origin and not to impose restrictive regulations on trade in these goods.

The following products will be exempt from China import duty from 1 January 2004 provided that they meet the CEPA rules of origin requirement:

- **Electrical and electronic products** such as motors, generators, transformers, converters, certain batteries, certain mechanical tools and appliances and their parts, certain parts for audio-visual appliances etc.
- **Plastic articles** such as certain polystyrene and polyvinyl chloride in primary forms, certain plastic materials and scraps etc.
- **Paper articles** such as specified papers, paperboards and corrugated papers, specified printed matters etc.
- **Textiles and clothing** such as certain yarns and fabrics, parts of garments, shirt, blouses, pullovers etc.
- **Chemical products** such as lubricating oil, certain pigments, dyes, paints etc.
- **Pharmaceutical products** such as medicaments containing penicillin, certain Chinese patent medicines etc.
- **Clocks and watches** such as certain electrically operated clocks and watches, certain watch movements, cases, straps and other parts for clocks and watches etc.
- **Jewellery** such as articles of gold, silver and other precious metals and parts thereof, articles of pearl, precious and semi-precious stones etc.
China

- **Cosmetics** such as eye, lip, manicure and beauty make-up preparations, perfumes etc.
- **Metal products** certain materials and articles of metals including steel, aluminium, copper etc.
- **Other products** such as certain optical appliances and parts thereof, photographic cameras, ice cream, certain leather etc.

For other trade measures, the two sides agree not to take anti-dumping, countervailing and certain specific safeguard measures against goods of the Mainland or Hong Kong origin. At the same time, the Mainland agrees not to apply tariff rate quotas against goods of Hong Kong origin.

**On the Provision of Services**

Hong Kong Company engages in 18 sectors will benefit in terms of additional market access or removal of specific restrictions in the Mainland market. They include management consultancy, exhibitions and conventions, advertising, legal, accounting, medical and dental services, real estate and construction, transportation, distribution, logistics, forwarding, storage, tourism, audiovisual, banking, securities, insurance and telecom value added services. A brief summary of the accession timeline and requirements for CEPA and the comparison with the WTO provisions, where possible, is attached.

It is also important to note that in order to enjoy the preferential treatments granted under CEPA, Hong Kong Companies should meet the criteria of “service suppliers” as stipulated under the CEPA. However, companies should pay attention that definitions of “service suppliers” vary among different sectors, general determining factors are:

- Registered and established in Hong Kong;
- Company is in similar sector and scope of business in Hong Kong;
- The company must pay profits tax in Hong Kong. However, in case of a loss situation, the company will still meet the requirement if it can prove that it has engaged in substantive business in Hong Kong;
- The company must own or rent business premises in Hong Kong to engage in substantive operations; and
- Must employ in Hong Kong 50% or more of its total staff.

Additional requirements may be needed for special service sectors, e.g. shipping and banking. In view of this, companies shall evaluate their own position very carefully to see whether they meet the definition of qualifying “service suppliers” in a particular sector in order to enjoy the preferential treatments under CEPA.

For a Hong Kong “service supplier” that has been acquired by or merged with service suppliers other than those of the two sides (i.e. the Mainland China and Hong Kong) on or after the day CEPA comes into effect, and as a result of the acquisition or merger, the latter service suppliers (i.e. non-Mainland or non-Hong Kong service suppliers) have acquired more than 50% equity interest of the Hong Kong “service supplier”, that Hong Kong “service supplier” will only be regarded as a Hong Kong Service Supplier” under CEPA after one year of the acquisition or merger.

**With regard to Trade and Investment Facilitation**

Both sides agree on promoting co-operations in 7 areas, namely, customs clearance; quarantine and inspection of commodities; quality assurance and food safety; stronger support for small and medium-sized enterprises; Chinese medicine and medical products; electronic commerce; trade and investment promotion; and transparency in laws and regulations.

CEPA liberalises the trade in goods and services as well as enhance the world leading position of Hong Kong as a global platform for China business. The current CEPA covers broad areas and many definitions and details will be supplemented as time goes by. Companies may want to re-visit their strategies in China in light of the CEPA, to take advantage of the special concessions given to Hong Kong products and Hong Kong Companies.
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<th>Service sector</th>
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<th>WTO and national accession requirements</th>
<th>Remark</th>
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</thead>
<tbody>
<tr>
<td>1. Management consulting (other than legal,</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>WFOE by 11 Dec 2007</td>
<td>4 years ahead</td>
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<td>accounting, auditing and certification)</td>
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<tr>
<td>2. Convention services</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>WFOE from 22 February 2004 onwards</td>
<td></td>
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<td>3. Advertising services</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>WFOE by 10 Dec 2005</td>
<td>2 years ahead</td>
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<tr>
<td>4. Accounting services</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.1 Real estate</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>Not allowed to engage, in WFOE form, in</td>
<td>Validity of &quot;temporary audit business permit&quot; extends from 6 to 12</td>
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<td>activities relating to self-owned or</td>
<td>higher standard real estate projects</td>
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<td>leased properties for high standard</td>
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<td>real estate projects</td>
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<td></td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>Majority JV allowed for real estate</td>
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<td>development on a fee or contract basis</td>
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<td>5.2 Construction professional services</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>Majority JV now and WFOE by 11 Dec 2006</td>
<td>3 years ahead</td>
</tr>
<tr>
<td>5.3 Construction and professional engineering</td>
<td>Allowed 100% acquisition of</td>
<td>Majority JV now and WFOE by 11 Dec 2004</td>
<td>1 year ahead</td>
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<tr>
<td>related services</td>
<td>domestic construction</td>
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<td></td>
<td>enterprises</td>
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<td></td>
<td>No restriction on project</td>
<td>J V is subject to restrictions on project</td>
<td>Relaxed allowable business scope</td>
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<td>type</td>
<td>type before 11 Dec 2004</td>
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<td>WFOE is subject to restrictions on</td>
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<td>project type even after 11 Dec 2004</td>
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<td>6. Medical and dental services</td>
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<td>Qualified HK doctors can provide short term medical services for a</td>
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<td>max of 3 years as compared to 1 year in the past</td>
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<tr>
<td>7.1 Distribution services</td>
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<td></td>
<td>1 year ahead. Lower entry requirements, for example, annual sales</td>
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<tr>
<td>- Commission agents' services and wholesale services (excluding salt and tobacco)</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>WFOE by 11 Dec 2004</td>
<td>value requirement and registered capital etc. Wholly owned overseas</td>
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<td>trading companies allowed. Enterprises engaged in the distribution</td>
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<td>of books, newspapers, magazines, pharmaceuticals, pesticides,</td>
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<td>mulching film, chemical fertilizers, staple food, vegetable oil,</td>
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<td>edible sugar, cotton and processed oil remain subject to China’s</td>
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<td>commitments under the WTO</td>
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<tr>
<td>7.2 Distribution services</td>
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<td>1 year ahead. Lower entry requirements, for example, annual sales</td>
</tr>
<tr>
<td>- Retail services (excluding tobacco)</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>WFOE allowed by 11 Dec 2004</td>
<td>value requirement and registered capital etc. Retailing companies</td>
</tr>
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<td></td>
<td>(large department stores and chain stores more than 30</td>
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<td>allowed in all cities at prefectural level in the Mainland and at the</td>
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<td>outlets still subject to minority equity)</td>
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<td>county level in Guangdong Province. Individual owned retail stores</td>
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<td>by Hong Kong permanent residents of Chinese nationality are permitted</td>
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<td>in the Guangdong Province. Enterprises engaged in the distribution</td>
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<td>of books, newspapers, magazines, pharmaceuticals, pesticides,</td>
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<tr>
<td>7.3 Distribution services - Franchising services</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>No foreign investment allowed until 11 Dec 2004</td>
<td>1 year ahead. Relevant regulations for franchising will be announced later</td>
</tr>
<tr>
<td>8. Logistics and certain types of related consultancy services</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>Different restrictions on transportation, storage and warehousing apply</td>
<td></td>
</tr>
<tr>
<td>9. Freight forwarding agency services</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>Majority J V now and WFOE by 11 Dec 2005</td>
<td>2 years ahead and lower registered capital requirement</td>
</tr>
<tr>
<td>10. Storage and warehousing</td>
<td>WFOE allowed on 1 Jan 2004 and follow capital requirement of domestic enterprises</td>
<td>Majority J V by now and WFOE by 11 Dec 2004</td>
<td>1 year ahead and lower capital requirement</td>
</tr>
<tr>
<td>11.1 Transport services - Road</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>Majority J V by now and WFOE by 11 Dec 2004</td>
<td>1 year ahead and permitted to provide direct non-stop road freight transport services between Hong Kong and each province in the Mainland. WFOE allowed in Western Region of the Mainland to provide road passenger transport services</td>
</tr>
<tr>
<td>11.2 Transport services - Marine</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>J V (stakeholding restriction depending on type of business)</td>
<td>Higher foreign stakeholding percentage</td>
</tr>
<tr>
<td>12.1 Tourism - hotels and restaurants</td>
<td>WFOE allowed on 1 Jan 2004</td>
<td>Majority J V now and WFOE by 11 Dec 2005</td>
<td>2 years ahead</td>
</tr>
<tr>
<td>12.2 Tourism - travel agency</td>
<td>Minority J Vs allowed with no geographical location restriction</td>
<td>J V in Beijing, Shanghai, Guangzhou and Xian</td>
<td></td>
</tr>
<tr>
<td>13.1 Audiovisual services - video and sound recording products distribution</td>
<td>Majority J V (not exceeding 70%) and allowed distribution of audiovisual products (excluding products on motion pictures)</td>
<td>Minority J V for distribution of audiovisual products (excluding products on motion pictures)</td>
<td>Higher foreign stakeholding percentage and relaxed business scope</td>
</tr>
</tbody>
</table>
### Service sector

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<thead>
<tr>
<th>Service sector</th>
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<th>Remark</th>
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<tbody>
<tr>
<td>13.2 Audiovisual services – motion picture</td>
<td>No quota for Chinese language motion pictures produced by HK companies and motion pictures jointly produced by HK and the Mainland are to be treated as mainland movies</td>
<td>Importation quota for motion pictures</td>
<td>Enjoy national treatment</td>
</tr>
<tr>
<td>13.3 Audiovisual services – cinema theatre</td>
<td>Majority J V (with the stakeholding percentage not exceed 75%)</td>
<td>Majority J V (with the stakeholding percentage not exceed 75%) from 1 January 2004 onwards</td>
<td>Residency requirement for representatives of RO of a lawyer firm is relaxed. In Guangzhou and Shenzhen, such requirement is waived. Other practicing requirements are also relaxed</td>
</tr>
<tr>
<td>14. Legal services</td>
<td>Asset requirement reduced to USD6 billion</td>
<td>Asset base requirement is USD20 billion (for branch) and USD10 billion (for J V or WFOE)</td>
<td>Relaxation of entry requirement</td>
</tr>
<tr>
<td>15. Banking</td>
<td>No requirement for setting up RO prior to any investment in China entity and 2-year business history for RMB business</td>
<td>Required to set up RO prior to any investment in China entity such as J V bank and 3-year business history for RMB business application</td>
<td>Relaxation of entry requirement</td>
</tr>
<tr>
<td>16. Securities</td>
<td>Investment cap for investment in domestic insurance enterprise is 24.9%</td>
<td>Investment cap for investment in domestic insurance enterprise is 10%</td>
<td>HK Stock Exchange is allowed to set up a RO in Beijing. Relaxing practicing requirements for securities professionals.</td>
</tr>
<tr>
<td>17. Insurance</td>
<td></td>
<td></td>
<td>Market entry requirements remain the same, for example asset base is USD5 billion and 30-year business history and set up RO in China over 2 years, except that it can be met by way of strategic merger under CEPA</td>
</tr>
<tr>
<td>Service sector</td>
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</table>
| 18. Telecom value-added services | Allow to form JV of not exceeding 50% without geographical restriction on 1 October 2003 to engage in the below services:  
1) internet data centre services;  
2) store and forward services;  
3) call centre services;  
4) internet access services;  
5) content services. | JV of not exceeding 50% without geographical restriction allowed by 11 December 2003 |                                                                        |

Abbreviation:  
RO - Representative Office  
JV - Joint Venture  
WFOE - Wholly Foreign Owned Enterprise  
HK - Hong Kong Special Administrative Region
J O I N T P E T R O L E U M
D E V E L O P M E N T A R E A ( J P D A)
Taxation Update

The Government of East Timor passed, in mid-
2003, the Timor Sea Petroleum Development
ToBUCA.

The intended effect of the new laws is to establish
a more stable tax regime and, in doing so, provide
protection to investors from the increases in
general tax rates. The new laws solely relate to
activities within the Bayu-Under contract area (that
is Production Sharing Contracts (PSCs) J PDA 91-
12 and 91-13, except the Elang Kakatua Kakatua
North field). The new laws, including other oil and
gas concessions in the J PDA, do not relate to the
rest of East Timor.

Outlined below are the major changes to East
Timor taxation in the Bayu-Under contract area that
taxpayers should be aware of:

- Various withholding and final tax rates (including
  those on drilling and shipping services) have
  been lowered depending on the nature of the
  activity being undertaken.

- Branch profits tax no longer applies to
  contractors and certain subcontractors.

- New “additional profits tax” (APT) has been
  created. This tax applies to contractors on any
  positive accumulated net receipts derived in a
  fiscal year.

- Contractors can now claim deductions for
decommissioning expenditure incurred in a fiscal
  year (post 1 January 2008).

- Changes have been made to the depreciation of
tangible property and amortisation of intangible
  property for contractors.

- The value of natural gas is to be in accordance
  with the relevant PSC.

- A general tax exemption applies to income and
  activities relating to the construction, institution
  and operation of an export pipeline.

The changes resulting from the introduction of the
new laws, including the withholding tax reductions,
are retrospective to 1 January 2002. In this regard,
some taxpayers may be eligible to apply for
refunds of withholding tax paid under the former
higher rate.
2004/05 BUDGET PROPOSALS

The new Financial Secretary (Henry Tang) did not propose any significant tax measures in his maiden budget speech delivered on 10 March 2004, other than reconfirming the Government's view that it is necessary in the long term to introduce Goods and Services Tax (GST) to broaden the tax base and secure a stable source of public revenue. He announced that the Government has set up an internal committee to conduct a detailed and comprehensive study on the implementation of a GST in Hong Kong. It is not expected that such a tax would be implemented before 2008.

IMPLEMENTATION OF THE 2003-2004 BUDGET PROPOSALS

As mentioned in the previous edition of Asia Pacific Tax Notes, the then Financial Secretary (Anthony Leung) delivered his 2003-04 Budget speech on 5 March 2003. The 2003-04 Budget included quite a large number of measures to stabilise revenue collections, to broaden the tax base and to help reduce the budget deficit and ensure financial stability. However, not all the proposed measures have been enacted into law.

Proposals which have been enacted, include:

1. Certain revenue raising proposals relating to salaries tax, profits tax and property tax. In particular, the increase in the rates of taxes, the increase in the rate (from 10% to 30%) to compute the deemed assessable profits of non-residents not carrying on a trade or business in Hong Kong (HK) on certain royalties and licence fees accruing or paid to them from HK, the reduction in personal allowances, the narrowing of the salaries tax bands, and the abolition of the salaries tax exemption for holiday warrants and passages.

2. The proposal to increase motor vehicle first registration tax. This budget proposal was however watered down in the legislative process with the proposed tax of 150% on private cars with taxable values over HK$500,000 being reduced to 100%.

3. The proposal to grant a 50% concession on profits tax on trading profits from qualified debt instruments with a maturity period of less than seven years but not less than three years, and a 100% concession for qualified debt instruments with a maturity period of seven years or more.

4. The proposal to amend the Stamp Duty Ordinance to exempt instruments of transfer relating to the issue or redemption of units from unit trust funds domiciled in Hong Kong from the fixed duty of HK$5.

TAXATION OF HOLIDAY WARRANTS AND PASSAGES

Following the abolition of the HK salaries tax exemption for holiday warrants and passages, the Inland Revenue Department (IRD) issued in August 2003 a Departmental Interpretation and Practice Notes (DIPN) No. 41, Salaries Tax - Taxation of Holiday Journey Benefits, to provide information and guidance on the application of the new rules from 1 April 2003. Under the new rules, any amount paid by an employer in connection with a holiday journey will be included in the assessable income of the employee.

The IRD has taken a very broad interpretation of “holiday journey” in DIPN No. 41 and even considers a one-day HK tour provided by an employer for a group of employees to be a holiday journey for the purpose of applying the new legislation (see paragraph 18 of DIPN No. 41). One wonders whether it really was the legislative intent that a one-day outing in HK, that begins and ends at one’s home, should be regarded as a “journey”.

As well as providing guidance on the application of the new rules, including a number of examples, it provides information on the arrangements for the transition from the old to the new rules.

CLOSER ECONOMIC PARTNERSHIP ARRANGEMENT

The governments of the People’s Republic of China (the mainland) and the HK Special Administrative Region have signed a Closer Economic Partnership Arrangement (CEPA) on 29 June 2003. CEPA is effective from 1 January 2004. CEPA is aimed at strengthening trade and investment co-operation and promoting further economic links between the mainland and HK. It is also intended to boost the Hong Kong economy by way of lifting customs
Some of the interesting features of the DTA are as follows:

1. The definition of “a resident in a Contracting Party” in Article 4 of the DTA follows the standard Organisation for Economic Cooperation and Development (OECD) definition. However, since HK does not tax a person by reason of his domicile, residence or place of management or incorporation, the term “resident of a Contracting Party” is now amended in item 2 of the Protocol to the DTA for the purpose of its application in HK as follows:

“It means:

- any individual who ordinarily resides in HK in a year of assessment;
- any individual who stays in HK for more than 180 days during a year of assessment or for more than 300 days in two consecutive years of assessment, one of which is the relevant year of assessment;
- a company incorporated in HK or if incorporated outside HK having its central management and control in HK; or
- any other person constituted under the laws in force in HK or if constituted outside HK having its central management and control in HK.

It also does not preclude a person from being treated as a resident in HK by reason of a territorial source principal in the taxation system of HK.”

Effectively, a branch of a foreign company whose central management and control is not in HK would not meet the definition of “resident in a contracting party” even though it is subject to HK profits tax on the branch’s income.

2. Under Article 14 “Income from employment”, besides the three standard OECD exemption conditions, there is a fourth condition, “the remuneration is taxable in the first-mentioned Party according to the Laws in force in that Party”, which has to be met. It appears that an individual who uses the days-in-days-out (DIDO) basis for salaries tax reporting purposes may not be able to claim treaty exemption in Belgium for remuneration derived from exercising the employment in Belgium.
3. The "Exchange of information" article (Article 25) is along the lines of the standard OECD article. It has included the decisions of Board of Review as judicial decisions and also contains a restriction that information received by the competent authorities of Belgium can only be released to a third party with the consent of the competent authorities of HK.

4. There is no specific “limitation of benefits” article.

The DTA also offers favourable withholding tax rates. The following is a comparison of the withholding tax rates for dividend, royalty and interest:

<table>
<thead>
<tr>
<th></th>
<th>Dividend</th>
<th>Royalty</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>non-treaty rate</td>
<td>25%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>HK non-treaty rate</td>
<td>Nil</td>
<td>5.25%</td>
<td>Nil</td>
</tr>
<tr>
<td>Treat rate</td>
<td>0% / 5%</td>
<td>5%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Whilst Clause 2 of the dividend article, Article 10, does impose a 5% or 15% WHT on dividends where the shareholding is at least 10% or less than that respectively, the clause goes on to say that the withholding tax (WHT) will be nil where the shareholder has directly held at least 25% for an uninterrupted period of at least 12 months as at the dividend payment date. This raises a number of potentially interesting issues from a tax structuring point of view for Hong Kong based groups and may make structuring into Europe or other locations through either Holland or Luxemburg, via Belgium attractive.

The 5% WHT on royalties provided for in Article 12 would seem to offer some relief to a Belgium recipient of certain royalties from HK, which would otherwise be subject to HK tax at 5.25%.

Hong Kong is not only a low tax jurisdiction it does not tax offshore profits and has a zero WHT on dividends and interest. This coupled with the Belgium participation concessions, is likely to result in various planning possibilities.

As India is going in for the General Elections this year, the Finance Minister has placed an Interim Budget 2004-05 on 3 February 2004 before the Parliament was dissolved. Though the prelude to the budget proposals mentioned that it is aimed at discharging the responsibilities and meeting the essential expenditure during the first four months of 2004-05 (i.e. effective from April 2004), it has been clarified that the demands for Grants and the Annual Financial Statement presented are for the full financial year, which could be revised at the time of presentation of the regular Budget after the new government is formed.

**DIRECT TAXES**

While there is no proposal for amendment in the provisions, there has been some procedural changes though the tax rates remain as follows:

- Tax rate remains at 35% for domestic companies and 40% for foreign companies while surcharges remain at 2.5% thereon taking the effective rate to 35.875% and 41% respectively.

- Domestic companies continue to pay dividend distribution tax at 12.8125% (12.5% plus surcharge at 2.5% thereon) on dividends declared, distributed or paid.

The changes suggested are as follows:

- Fiscal benefits available to new projects in the power sector to be extended to 2012, instead of 2006, and also to be available to cases of take-overs by State Electricity Boards.
The regime of listed equities acquired on or after 1 March 2003 being exempt from long-term capital gains tax to be extended for a further period of three years.

To provide a level playing field for the Indian shipping business, a tonnage tax scheme has been proposed that could impose a fixed rate of tax on notional income on the basis of net registered tonnage.

As Business Process Outsourcing is a major source of employment generation in India, it has also been proposed that no tax will be levied on the foreign company that outsources its activities to India if such outsourced services are ancillary and auxiliary in nature and adequate remuneration is paid to the Indian call center of the foreign company.

The Revenue had in fact issued a Circular earlier in January this year stating that where a non-resident outsources the whole or part of its core revenue generating business to an IT-enabled entity in India and the services are rendered directly to the customers abroad or through a non-resident principal, a considerable portion of the profit derived by the non-resident or foreign company would be attributable to the activities provided in India and thereby subject to tax in India. However, the Circular also clarified that in case the non-resident outsources some of its incidental activities like conclusion of contracts and procurement of orders (which enables conclusion of contracts to be carried out abroad), the insignificant profit would not be taxable in India if the price charged by the permanent establishment in respect of the above services is at arm’s length / fair market price. The topic is currently under a lot of debates in the country and the final stand will evolve with time.

INDIRECT TAXES

There has been reduction in indirect taxes by notification earlier in January this year:

**Customs Duty**

- The peak rate of basic customs duty has been reduced from 25% to 20%.
- All goods have been exempted from the special additional duty (SAD) of customs of 4%.
- The basic customs duty on project imports has been reduced from 25% to 10% in case of all projects (including ongoing projects) with an investment of at least INR 50 million (approximately US$1.1 million) in plant and machinery (excluding land and buildings).
- The basic customs duty on Information Technology Agreement (ITA) bound items has been reduced. The basic customs duty on specified IT / electronics / telecom related items has been reduced by 5 percentage points.
- Exemption from payment of basic customs duty on specified infrastructure equipment for basic / cellular / internet, V-SAT, radio paging and public mobile radio trunked services has been extended to 31 March 2005.
- The present exemption from customs duties available to water supply projects for drinking purposes is being extended to water supply projects for industrial and agricultural purposes as well.

**Excise Duty**

- Excise duty rate on computers is now reduced from 16% to 8%.

The Interim Budget did not propose any further changes in customs (import) duties, excise (on manufacture) duties (CENVAT) or service tax. It however proposed several procedural simplifications in the indirect tax regime with the overriding objective of reducing transaction costs for assessments by minimising paper work and the contact points with the tax authorities. The following are the key measures on procedural simplifications:

- Extension of round the clock electronic filing of customs documents for clearance of goods from the present 4 locations (metros) to 23 more customs stations by 31 March 2004.
- Customs clearances to be based on self-assessment and selective examination effective from 30 June 2004.
- Adoption of the eight-digit excise classification of goods by 30 September 2004 to achieve transparency, avoid classification disputes and harmonize the excise, customs and Exim Policy nomenclatures.

In addition, the suggestion for providing the benefit of CENVAT credit on the countervailing duties paid by the power sector on its imports will also be examined.
TAX REFORM

Like other governments in the Asia Pacific region in recent years, the Indonesian Government has initiated a process of tax reform.

One of the major drivers of the reform process has been a recent International Monetary Fund’s (IMF) investigation into Indonesia’s fiscal sustainability, which led to the IMF reporting that tax receipts in Indonesia are still relatively low compared with international standards. The IMF’s report suggested reforming tax policy with a focus on:

- Increasing tax revenue;
- Simplifying the tax system; and
- Increasing economic efficiency.

The World Bank, through its work in Indonesia, has also stated that it believes the current tax system in Indonesia is no longer conducive or competitive for investors in Indonesia, due to factors such as an uncompetitive tariff sector, unfair and vague regulations and legal uncertainty.

The need to reform Indonesia’s fiscal administration system has resulted in a draft revision of the country’s tax laws. These proposed amendments to the income tax and value added tax laws were presented in a draft submission to the Indonesian Parliament recently.

At this stage, the Director General of Taxation (DGT) has advised that the revised tax laws are intended to be operative from 1 January 2005. Outlined below are highlights from the draft submission.

Income Tax

- The tax-free threshold for individuals is proposed to be increased (by 100% in most cases). The proposed non-taxable income amounts proposed are as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual taxpayers</td>
<td>Rp 5,760,000</td>
</tr>
<tr>
<td>Married taxpayers</td>
<td>Rp 1,440,000</td>
</tr>
<tr>
<td>Working wives</td>
<td>Rp 5,760,000</td>
</tr>
<tr>
<td>All dependents</td>
<td>Rp 1,440,000 (maximum of 2 children)</td>
</tr>
</tbody>
</table>

- Withholding tax rates under Article 21 are proposed to be differentiated, based on whether the employee has a tax identification number (NPWP) or not. For individuals who have NPWP, the tax rates will remain at 10% to 35%. For individuals who do not have a NPWP, the tax rate will now be 20% to 45% or more.

- Withholding tax rates under Article 23 will also be differentiated, based on whether the taxpayer has a NPWP or not. The rate will remain at 15% for those who have a NPWP, but will increase to 25% for those who do not have a NPWP.

- A flat corporate tax rate of 28% will replace the current progressive corporate tax rate. In some circumstances, the rate may be reduced to 25%.

- It is proposed that loss carry forward rules will be tightened so that losses from “active” activities can only be offset against “active” income, whilst losses from “non-active” activities can only be applied against “non-active” activities. In addition, losses will be segmented into domestic and foreign losses.

- The current ability to undertake a balance sheet re-organisation in order to remove retained losses from a balance sheet (by reducing capital yet still use the losses) is proposed to be changed such that the losses can no longer be utilised.

- It is proposed that, as an anti-avoidance mechanism, the DGT be authorised to stipulate a minimum amount of tax that must be paid by taxpayers that constantly incur losses.

- Broadening / strengthening the definition of tax subjects is proposed, such as including in the definition of “Permanent Establishment” warehouses used by foreign taxpayers for uses other than storage / display of goods.

- Broadening / strengthening the definition of tax objects is proposed, such as including all derivative transactions (e.g. warrants, options, rights), and bond interest received by a mutual fund company, within the definition of tax object.

- Foreign exchange rate gains/losses are proposed to be calculated based on a realised basis.

- Interest withholding tax is proposed to be based on the time of payment or maturity.
Indonesia

- Changes to withholding tax exemptions for banks are proposed.
- Grants are proposed to be taxable.
- Changes to the categories of taxpayers who can use calculation norms when calculating net income for income tax purposes are proposed.
- Various changes to the monthly income tax payment/reporting system are proposed.

Value Added Tax (VAT) and Luxury Sales Tax (LST)
- It is proposed that exporters that have sales transactions with VAT collectors and complying taxpayers may request monthly VAT refunds while others will only be able to request refunds on an annual basis.
- It is proposed that current administrative issues caused by deliveries of goods between branches and multi-VAT registration be overcome by relaxing the VAT centralisation process.
- Export services will not be subject to VAT.
- VAT exemptions for organisations undertaking a restructuring will be reinstated.
- The period for crediting of input VAT will be reduced to 2 months (from 3 months).
- Currently the VAT law does not fully regulate the VAT treatment of taxable “services”. It is proposed that the law be amended to properly accommodate taxable services.

General Tax Procedures
- Tax penalties for late submission of tax compliance obligations will be increased significantly.
- US dollar bookkeeping is proposed to be abolished.

NEW TAX TREATY BETWEEN INDONESIA AND THE NETHERLANDS

A new tax treaty between Indonesia and the Netherlands has now been ratified and the diplomatic procedures have been completed. Accordingly, the treaty became effective on 1 January 2004.

The main differences between the old and the new treaties are listed as follows:

- The rate of dividend withholding tax will be 10% for all dividends. In the old treaty, the 10% rate was only applicable in instance that the relevant shareholdings were more than 25%.
- The rate of branch profits tax is increased from 9% to 10%.
- The rate of interest withholding tax is reduced to nil for interest payments relating to loans made for a period of more than 2 years or loans made in connection with the sale on credit of any industrial, commercial or scientific equipment. The rate will still be 10% for any other interest payments.

Clauses on the disposal of substantial shareholdings (more than 5%) by individuals, on pensions and on offshore activities, were also amended or introduced in some instances. These changes mainly extend the Dutch tax base.

The elimination of interest withholding tax for qualifying loans seems to offer scope for tax planning opportunities since this is the only treaty to date that offers this opportunity.
2004 Japanese tax reform was enacted as of 1 April 2004. A summary is given below. The Ministry of Finance expects that this year’s tax reform will result in a tax cut of approximately 1.5 trillion Japanese yen (JPY) at the national tax level.

SUMMARY

1. Corporate Tax
   - Extension of period for loss carry forwards and tax audit adjustment
   - Abolition of surtax on consolidated tax filing
   - Deductibility of tax losses when private funds are offered by directors or shareholders in case of an assets arrangement

2. International Taxation
   - Changes relating to the new Japan-US Tax Treaty
   - Relaxation of rules for identifying comparables for thin capitalization purposes
   - Amendment of withholding tax exemption procedures
   - Changes in transfer pricing legislation

3. Finance and Securities Taxation
   - Income tax treatment of Publicly Offered Stock Investment Funds
   - Tax rate reduction on capital gains on unlisted stocks
   - Allowing financial institutions to operate special accounts
   - Withholding tax exemption on redemption gains

   - Measures to promote business succession
   - Tax incentives to support qualified ventures

5. House and Land
   - Housing-loan related tax reductions
   - Amendment of capital gain taxation of land

6. Pension
   - Increased maximum permissible contribution to defined contribution pension plan
   - Amendment of public pension taxation

7. Local Taxes
   - Changes relating to the introduction of factor-based taxation
   - Abolition of national cap on locally-determined fixed assets tax rate
   - Per capita tax

DETAILS

1. Corporate Tax

   (1) Extension of period for loss carry forwards and tax audit adjustment

   **Principal change**

   Previously, tax losses arising in one year could be offset against taxable income arising in the following 5-year period. This period is extended to 7 years for losses incurred in fiscal years starting on or after 1 April 2001.

   **Extension of period for which books and accounting records must be maintained**

   Previously, books and accounting records must be maintained for 5 or 7 years. In line with the extension of the loss carry forward period, the period for which books and accounting records must be maintained is also extended from 5 years to 7 years. This applies to books and accounting records of fiscal years starting on or after 1 April 2001.

   **Extension of period for which fiscal years remain open to audit**

   The period in which the tax authorities may make adjustments to a tax loss carried forward that was incurred in a given fiscal year is extended from 5 years to 7 years, for tax losses incurred in fiscal years starting on or after 1 April 2001.
Japan

- The period in which the tax authorities may adjust a company's reported taxable profit, correcting understatements other than those due to deliberate tax evasion, is extended from 3 years to 5 years. This change applies to fiscal years where the corporate tax return is due on or after 1 April 2004.

(2) Abolition of surtax for filing consolidated return
The 2% surtax applies to taxable profits reported in a consolidated tax return is abolished for fiscal years starting on or after 1 April 2004.

(3) Deductibility of tax losses when private funds are offered by directors or shareholders in case of an assets arrangement
As with the deductibility of tax losses for private funds that are offered by directors or shareholders, etc, in the case of an assets arrangement, the amount of loss deductible is currently the amount of loss carried forward after reducing capital surplus for tax purposes. Under the revised law, the deductible tax losses are not reduced by the capital surplus.

2. International Taxation

(1) Changes relating to the new Japan-US Tax Treaty
On 6 November 2003, Treasury Secretary John W. Snow and the Japanese Ambassador to the US, Ryozo Kato, signed the new US-Japan double tax treaty. The treaty was ratified by both governments and became effective on 30 March 2004. The new treaty (together with the appended protocol and exchange of notes) represents a complete modernisation of the existing treaty, now more than 30 years old.

The treaty ushers in lower rates of withholding tax and has thus received favorable press coverage. However, these lower rates are not automatic and must pass new and stringent anti-avoidance provisions, such as the detailed limitation on benefits article, introduced for the first time into Japanese tax treaties. This may add onerous compliance obligations on taxpayers wishing to take full advantage of the treaty benefits.

Some of the interesting features of the treaty and tax reform changes relating to the treaty are as follows:

New withholding tax rates

<table>
<thead>
<tr>
<th></th>
<th>NEW</th>
<th>EXISTING</th>
</tr>
</thead>
<tbody>
<tr>
<td>DIVIDENDS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Beneficial owner</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt; 50% of voting</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td>stock of payer</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Beneficial owner</td>
<td></td>
<td></td>
</tr>
<tr>
<td>at least 10% of</td>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>voting stock of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>payer</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Pension funds</td>
<td>0%</td>
<td>20%</td>
</tr>
<tr>
<td>- All other dividends</td>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td>ROYALTIES</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td>INTEREST</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Financial Services</td>
<td>0%</td>
<td>10%</td>
</tr>
<tr>
<td>companies or pension</td>
<td></td>
<td></td>
</tr>
<tr>
<td>funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Others</td>
<td>10%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Dividends
This is one of the first US treaties (along with Mexico, Australia and the UK) to include a zero dividend withholding tax, which gives investors the opportunity to extract funds from subsidiaries with potentially no tax cost for US holding companies and may offer Japanese parent companies a timing advantage. The zero rate is only available to certain holdings of greater than 50% held for more than 12 months preceding the dividend entitlement and to investments by pension funds, subject to restrictions. The rate for equity holdings of at least 10% has been reduced by half to 5% and in all other cases the rate is 10% of the gross dividend.

Royalties
Royalties will now be exempted from withholding tax. However, a 5% withholding may be imposed on that part of a royalty payment in excess of an arm's length rate where the parties are under a special relationship.

Interest
Financial services companies or pension funds will benefit from an exemption from interest withholding tax unless the interest is effectively connected with a permanent establishment. However, a 5%
withholding may be imposed on that part of an interest payment in excess of an arm’s length rate where the parties are under a special relationship. Interest withholding tax remains at 10% for other taxpayers.

Since the ratification occurred prior to 1 April 2004, the new treaty will apply to Japan or US withholding taxes effected from 1 July 2004. For changes affecting taxes other than withholding, the treaty applies for the taxable year beginning on or after 1 January 2005.

Ratification of the Organisation for Economic Cooperation and Development (OECD) Trends

The exchange of notes states that OECD rules on transfer pricing have precedent over domestic provisions.

This is consistent with regional developments (for example, the recent adoption of the Pacific Association of Tax Administrators transfer pricing documentation package) and some of the new wording (and consequently, their interpretation) is commensurate with the OECD Discussion Draft on the Attribution of Profits to Permanent Establishments. In addition, the protocol actually lists the detailed factors relevant for transfer pricing purposes.

Anti-avoidance Provisions

This is the first Japanese treaty to incorporate a comprehensive limitation on benefits article. This prevents benefits being claimed under the treaty unless the claimant also satisfies other tests (publicly traded test or a subsidiary of a publicly traded company test, active trade or business test or discretionary authority is given by the competent authority). There is a separate test for pension funds.

There are in addition a number of anti-avoidance provisions contained in the treaty. In particular, there are provisions that deny or restrict treaty benefits applicable to interest, royalties and other income to transactions under anti-conduit arrangements pursuant to the US or Japanese domestic law. The new anti-conduit rule for preferred stock is listed expressly in the treaty. These are intended to attack treaty shopping structures and arrangements. The interest, royalty and other income articles also introduce the notion of beneficial ownership for the first time.

The US and Japanese authorities have also reserved their powers to target a sleeping partnership (Tokumei Kumiai) and deny that entity and the partners treaty benefits that would otherwise arise under the (new) other income article. In addition, greater powers on information exchange have been reserved by the respective tax agencies.

Approval of qualification for the treaty benefit by the Competent Authority

Article 22 of the new treaty imposes conditions to be satisfied in order for treaty benefits to be available. If a taxpayer does not satisfy any of the qualifying conditions, it may as a last resort apply to the Competent Authority of the state from which benefits are claimed for treaty benefit eligibility. In the case of a US resident, an application should be filed with the Commissioner of National Tax Agency via the Kojimachi tax office director. If the application is approved, it will be announced in an official gazette. If the application is not approved, the applicant will be notified accordingly. Detailed procedures for Competent Authority approval are provided under a new Ministry of Finance Cabinet Order (“Cabinet Order with regard to Approval with regard to Tax Treaty for Contracting State Residents based on Special Treatment of Income Tax, Corporate Tax and Local Taxes” No. 25) issued on 31 March 2004.

Treatment of payments exceeding the arm’s length payment

Under the new treaty, if the amount of income within the “other income” articles of the new treaty exceeds the arm’s length amount for the transaction in question, the excessive amount may be subject to tax in the source country at a rate of not more than 5%. Necessary measures are set out in order to tax the excessive amount at the limited rate of 5%.

Other Areas

The treaty includes provisions dealing with US Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs) and other securitisation vehicles, shares in real property holding companies, the US excise tax on insurance policies, investment banking fees and clarification on the taxation of stock options in paragraph 10 of the protocol. Although Limited Liability Companies (LLCs) were not explicitly mentioned, they will clearly fall within the ambit of the treaty as there are detailed provisions affecting fiscally transparent entities. Revised domestic legislation is issued reflecting changes in the new treaty.
As a corollary to the strong anti-avoidance measures, specific provisions have been introduced to enable taxpayers to settle double tax disputes (notably, there is a seven-year time limit on transfer pricing enquiries and a stated intention to ensure competent authority resolutions are not drawn out).

Transitional period
It will be possible for taxpayers to elect to continue to apply the terms of the existing treaty for up to 1 year after the effective date of the new treaty.

(2) Relaxation of rules regarding comparables for thin capitalization purposes
Japanese thin capitalization rules allow the normal 3:1 debt-equity threshold to be exceeded where it can be demonstrated that a comparable third party has a higher gearing. The tax reform allows the taxpayer to refer to a single selected fiscal year from the comparable company’s past 3 years’ financial information, rather than needing to consider all 3 years. This change applies to fiscal years ending on or after 1 April 2004.

(3) Procedure to apply for withholding tax exemption
The procedure to apply for withholding tax exemption for non-residents and foreign corporations with permanent establishments in Japan is revised. Previously non-residents and foreign corporations must submit a certificate to the recipient in order to enjoy withholding tax exemption. After the revision, applicants for withholding tax exemption need only present a certificate to the recipient. This applies to domestic source income receivable on and after 1 July 2004.

(4) Changes in transfer pricing legislation - introduction of Transactional Net Margin Method (TNMM)
TNMM is introduced into the Japanese transfer pricing legislation. TNMM, as well as Profit Split Method, is added to the three currently used basic methods, i.e. Comparable Uncontrolled Price, Resale Price or Cost Plus Methods, to determine the arm’s length price in Japan.

The amendment applies to fiscal years beginning on or after 1 April 2004.

3. Finance and Securities Taxation
The following reforms are made in order to align the taxation of publicly offered stock investment funds with that of listed shares.

(1) Income tax treatment of publicly offered stock investment funds
(a) Capital gains realised on or after 1 January 2004 are subject to a reduced income tax rate (7% national tax and 3% local tax), this is already the case for capital gains on the sale of listed stocks.

(b) Publicly offered stock investment funds are added to the list of assets that may be held in a “special account”. Tax is then withheld from any resulting income, and no further tax liability will arise.

This applies to the following cases:

• Foreign publicly offered stock investment funds held in a “special account” which are transferred on or after 1 April 2004; and

• Domestic publicly offered stock investment funds and specified investment corporations held in a “special account” which are transferred on or after 1 October 2004.

(c) Capital losses incurred on the sale of publicly offered stock investment fund securities on or after 1 January 2004 may be carried forward for 3 years.

(d) When certain financial institutions repurchase investments from investors, and then subsequently redeem the investments on or after 1 April 2004, profit distributions from those redemptions may be exempt from withholding tax under certain conditions.

(2) Tax rate reduction on capital gains of unlisted stocks
The tax rate on capital gains on disposal of unlisted stocks realized on or after 1 January 2004 is reduced from the current rate of 26% (20% national tax and 6% local tax) to 20% (15% national tax and 5% local tax). Please note that stocks listed in an offshore stock market which are not sold through securities company in Japan are included in the unlisted stocks.
(3) Permissible operators of “special accounts”

Banks, Kyodososhiki-kyoynukikan and registered financial institutions are allowed to operate “special accounts” on or after 1 April 2004.

(4) Exemption of withholding tax imposed on redemption gains

(a) Redemption gains of short-term bonds held in a paperless trading system (so called “Denshi CP”) issued by foreign corporations are exempt from withholding tax at the time of issuance. This change applies to bonds issued on or after 1 April 2004.

(b) A system of payment slips concerning transfer and redemption of short-term bonds is introduced for transfers of short-term corporate bonds and foreign bonds on or after 1 April 2004.

(c) Redemption gains, in respect of discount short-term government bonds for which a paperless transfer is made, in an account opened by a qualified foreign intermediary, is exempt from withholding tax at the time of issuance. This applies to transfers on or after 1 April 2004.

4. Small-and-medium-sized enterprises

(1) Smooth business succession

In order to facilitate smooth inter-generation business succession, the following amendments are made:

(a) Taxation of capital gains on unlisted stocks used to finance inheritance tax payment

Previously, when unlisted stocks acquired by inheritance are sold to the issuing company in order to pay the inheritance tax liability, the capital gain arising from such transfer is subject to deemed dividend taxation (with a maximum tax rate of 50%), and the tax burden is heavier than that on a capital gain arising from transfer of listed stocks. Under the tax reform, the said capital gain is subject to taxation as a capital gain, and is not be subject to deemed dividend taxation. This new treatment applies to the transfer of unlisted stocks, acquired by inheritance, where the transfer occurs on or after 1 April 2004.

(b) Special treatment for family corporation

Where shares in a small- or medium-sized family corporation are acquired by inheritance, in determining the valuation of these shares for inheritance tax purposes, a 10% discount may apply to the first JPY300 million when certain conditions are met. This limit is increased from JPY300 million to JPY1 billion for assets acquired by inheritance or bequest on or after 1 April 2004.

(c) Non-application of family corporation surcharge

The surcharge levied on “excessive” retained earnings of a family corporation is suspended. This non-application is extended for 2 years (up to fiscal years ending 31 March 2006).

(d) Suspension of ability to carry-back tax losses

In principle, tax losses can be carried-back one year for national corporation tax purposes, but this ability to carry-back tax losses is suspended until 31 March 2004, except for certain small- or medium-sized companies. Both the suspension, and the exception for certain small- or medium-sized companies, are extended for 2 years up to fiscal years ending 31 March 2006.

(2) Measures to facilitate promotion of investment in ventures

The following amendments are made in order to support funding for ventures:

(a) The tax rate for capital gains on unlisted stocks is reduced to 20% (as per above).

(b) Expansion of the scope of angel taxation

The following companies are added to the scope of the application of the special treatment in which capital gains of stocks are only 50% taxable (so-called “angel taxation”), where the stocks are acquired by payment on or after 1 April 2004:

• Companies issuing stocks classified as “green sheet emerging”.
• Companies satisfying certain requirements (i.e. being invested in investment business limited partnership).
5. Housing and Land Taxation

(1) Special income tax deduction for housing loans
The special income tax deduction based on housing loan balances (so-called “housing-related tax reduction”) is maintained as for 2004.

Amount credited = Year-end housing loan balance (max. JPY50 million) x 1%

After 2005, the amount of the special tax deduction will be reduced gradually:

<table>
<thead>
<tr>
<th>Year housing occupation starts:</th>
<th>Period eligible for special deduction</th>
<th>Year-end loan balance</th>
<th>Applicable year, deduction rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>10 years</td>
<td>1st JPY50 million or less</td>
<td>1st to 10th year 1%</td>
</tr>
<tr>
<td>2005</td>
<td>10 years</td>
<td>1st JPY40 million or less</td>
<td>1st to 8th 9th, 10th year 1% 0.5%</td>
</tr>
<tr>
<td>2006</td>
<td>10 years</td>
<td>1st JPY30 million or less</td>
<td>1st to 7th 8th to 10th year 1% 0.5%</td>
</tr>
<tr>
<td>2007</td>
<td>10 years</td>
<td>1st JPY25 million or less</td>
<td>1st to 6th 7th to 10th year 1% 0.5%</td>
</tr>
<tr>
<td>2008</td>
<td>10 years</td>
<td>1st JPY20 million or less</td>
<td>1st to 6th 7th to 10th year 1% 0.5%</td>
</tr>
</tbody>
</table>

(2) Capital gains taxation of land
In order to balance the tax burden on land investments against that on stock investments (20% in principle), the following measures are taken:

(a) The tax rate on capital gains on land and buildings, where transfer occurs on or after 1 January 2004
   • The tax rate on capital gains on land and building(s) held for long term is reduced from 26% (national tax 20% and local tax 6%) to 20% (15% national tax and 5% local tax); and
   • The tax rate on capital gains on land and building(s) held for short term is reduced from 52% (national tax 40% and local tax 12%) to 39% (30% national tax and 9% local tax).

(b) Offsetting capital loss on land and buildings against other income
Previously, capital gains on land and buildings may be offset against other income (such as business profits and salary income) or may be carried forward to subsequent years for income tax purposes. Under the tax reform, these options cease to be allowed for national tax purposes for capital losses incurred on or after 1 January 2004, and for local inhabitants tax purposes for capital losses incurred on or after 1 January 2005.

Offsetting capital loss against other income remains possible where the gain arises from the sale of land or buildings for residential purposes.

(c) Loss carry forward for the transfer of certain residential assets
Previously capital losses may be carried forward for up to 3 years when the following conditions are met:
   • residential assets (land and buildings) are sold during the period from 1 January 1998 through 31 December 2003.
   • the assets have been held for more than 5 years prior to disposal and other residential assets are then purchased.
   • the annual income of the vendor is JPY30 million or less and they have a housing loan.

The applicable period for this measure is extended until 31 December 2006. Further, the requirement that the vendor has a housing loan is removed.
(d) Carry-over of capital loss on disposal of certain residential assets where no re-investment into residential assets occurs

Capital losses incurred from transfer of residential assets, which are held for more than 5 years and transferred between 1 January 2004 and 31 December 2006, may be carried forward for 3 years following the year in which the certain loss arose provided that certain conditions are met.

(e) Abolition of the special deduction of JPY1 million

Consistent with the reduction of the tax rate applicable to capital gains on land and buildings, the JPY1 million special deduction against the total capital gains on the transfer of land and buildings held for the long term is abolished. The JPY1 million special deduction is not available for income tax purposes for 2004 and thereafter, and for local tax purposes for 2005 and thereafter.

6. Pension

(1) Increase of maximum permissible contribution to defined contribution pension

Due to the declining benefits provided by the national pension system, the permissible contribution to defined contribution pensions is raised as follows:

<table>
<thead>
<tr>
<th>Type of pensions</th>
<th>Current (Monthly limitation) JPY’000</th>
<th>Current (Monthly limitation) JPY’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate type</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) If no other corporate pension is provided</td>
<td>36</td>
<td>46</td>
</tr>
<tr>
<td>(2) If some other corporate pension is provided also</td>
<td>18</td>
<td>23</td>
</tr>
<tr>
<td>Individual type</td>
<td></td>
<td></td>
</tr>
<tr>
<td>If a corporate pension is not provided</td>
<td>15</td>
<td>18</td>
</tr>
</tbody>
</table>

(2) Public pension allowances and allowances for aged people

The following principal amendments are made:

- The preferred tax treatment for persons aged 65 or more will be abolished, from 2005 onwards.
- Abolition of allowance for senior citizens: the tax credit of JPY500,000 for national tax (JPY480,000 for local tax) given to persons aged 65 or more provided that their annual income is 10 million yen or less, will be abolished with effect from 2005 for national tax and 2006 for local tax purposes.

7. Local Tax

(1) Factor-based taxation - Special treatment to deduct capital decrease without compensation from capital

Factor-based taxation, in which tax is imposed on factors such as personnel expenses and capital amount, applies from the fiscal years starting on or after 1 April 2004. This new tax was introduced by the 2003 Japanese tax reform, and applied to corporations whose capital amount exceeds JPY100 million.

In this regard, a special treatment is provided by the 2004 tax reform, to the effect that where a company performs a capital reduction in order to offset a profit and loss account deficit, on or after 1 April 2001, the capital as measured for factor-based taxation purposes is reduced accordingly. This special treatment applies only for 2 years i.e., for fiscal years starting on or after 1 April 2004, and until 31 March 2006.

(2) Abolition of the maximum tax rate for fixed assets tax

Fixed assets tax is a local tax, however, there is a national limit which prevents the tax rate being set higher than 2.1%. This limit is abolished, allowing local governments to decide the tax rate.

(3) Per capita tax

Previously the per capita local tax is charged at varying rates, between JPY2,000 and JPY3,000 per annum per person, depending on the size of the municipality. In 2005 and later years, a uniform rate of JPY3,000 per annum per person applies, regardless of the size of the municipality.
Amendments to various Korean tax laws became effective from 1 January 2004. Some of those amendments were made to the taxation of international transactions and Korean source income of non-residents. Provided below is a summary of selected Korean tax law changes that would be of particular interest to foreign investors or foreign investment companies in Korea.

### Income from Independent Personal Services

Under previous laws, income derived by a non-resident or a foreign corporation from the provision of independent personal services was treated as Korean source income and subject to a 22% Korean withholding tax if the services were performed in Korea, or if results of the services performed offshore were used in Korea.

However, under the revised regulations, income from independent personal services performed offshore will no longer be treated as Korean source income (even if the results of these services are used in Korea) and thus not be taxed in Korea.

This change is consistent with the rules on the taxation of such income under international tax treaties which Korea has entered into with 60 countries as well as the Model Income Tax Conventions of the Organisation for Economic Cooperation and Development (OECD) and the United Nation (UN). Under these rules, income from independent personal services shall be taxable in the state where the services are actually performed.

### Income from the Rental or Transfer of Machinery and Equipment

Prevailing Korean tax rules provide that where a foreign corporation (or non-resident) receives payment from the rental, transfer, or use of (or right to use) machinery, equipment, and installations to domestic (i.e. Korean) corporation or permanent establishments in Korea, the payments are characterised as Korean source royalty income and subject to 25% withholding tax in Korea, while a 2% Korean withholding tax applies to payments made to foreign corporations deriving income from the rental, transfer, use of (right to use) ships, aircrafts, registered automobiles and / or other heavy equipment.

Under the proposed legislative changes, payments received by a foreign corporation (or non-resident) from the rental of machinery, equipment, and / or installations to domestic corporations (or to permanent establishments in Korea) will be taxed in accordance with the rules for income from rental of ships, aircrafts, registered automobiles, etc., leading to a comparable 2% withholding tax in Korea.

Furthermore, payments received by a foreign corporation for the transfer of machinery, equipment and installations to domestic corporations, or to permanent establishments located in Korea, shall be treated as business profits of the foreign company, and subject to a 2% withholding tax rate in Korea.

### Profit Distribution through Unfair Related Party Capital Transactions

A new provision is enacted applicable to the taxation of profit distribution to foreign companies through unfair related party capital transactions. According to the new rule, in the event of unequal merger, capital increase or reduction and similar capital transactions between related parties, income arising from the appreciation of the value of shares held by specific foreign related parties in a domestic company as a result of such capital transaction will be taxed as Korean source income (i.e. other income) of the foreign related parties.
The domestic issuer of the concerned shares shall be liable to withhold tax on such income on the day the decision is made on capital reduction or additional capital injection. In the event of a merger, the withholding shall be made on the day the merger is filed and registered with the concerned tax office.

**Taxation of Foreign Expatriates’ and Employees’ Salary Income**

A significant change is made to the Korean taxation on salary income of foreign expatriates and employees working in Korea. According to the change that became effective from 1 January 2004, 30% of the salary income of foreign expatriates’ or employees’ working in Korea would not be taxable in Korea.

Furthermore, the foreign expatriates and employees would be able to opt to apply for a flat income tax rate of 18.7% (including resident surtax) on their salary income (rather than a progressive rate which currently ranges from 9% to 36% depending on an expatriate’s taxable income bracket). In this case, the above-mentioned 30% deduction of salary income, any other income deductions, tax exemption, and tax credit will be forfeited. If a foreign expatriate or employee wants to choose the 18.7% flat tax application, he/she is required to submit an application form to the Korean tax authorities.

In relation to the tax revision, the following provisions available to foreign expatriates were abolished:

- The exemption of an expatriate's overseas allowance of up to 40% of the expatriate's monthly salary income in the situation where the expatriate is paid overseas allowances.

- The deduction (up to a certain limit) of schooling tuition for the expatriate's dependent who goes to a foreign school in Korea, and rent for his/her housing in the situation where the expatriate is not paid overseas allowances.

That is, instead of the annulment of the current tax exemption of up to 40% of regular income for overseas allowance, foreign expatriates could choose their tax calculation method between the 30% income deduction and the 18.7% flat rate application, effective from 1 January 2004.

**Extension of Tax Incentive for Foreign Engineers**

The exemption from individual income tax applicable to foreign engineers and technicians will be extended for three additional years until the end of December 2006. In other words, the incentive shall be made available to qualifying foreign engineers or technicians who will have been employed or have commenced services in Korea no later than 31 December 2006.

The Korean tax law presently provides a tax incentive for foreign engineers and technicians as part of the effort to enhance the country’s competitiveness through the inducement of advanced technology. The tax incentive includes the exemption from individual income tax for five years from the date of employment (or service commenced) in Korea for wages and salaries received by:

- Expatriate technicians or engineers employed by Korean firms in qualified industries such as manufacturing, mining, computer software development, etc.; or

- Expatriate technicians or engineers who perform services under technical service agreements approved under the Foreign Investment Promotion Act.

**Withholding on Payment of Income to a Non-resident**

A company paying Korean source income to a non-resident or a foreign corporation having no PE in Korea is presently required to withhold a specified amount of tax at the time of payment and then remit the same to the government.

The withholding obligation shall be extended to payments of capital gains derived by a foreign corporation from the sale of real estate located in Korea. Under this new withholding obligation rule, a tax equivalent to 10% of the selling price of the real estate shall be withheld by the purchaser in the case where the non-resident's acquisition value of the real estate is unclear. On the other hand, a tax equivalent to the lesser of 10% of the selling price and 25% of the capital gains shall be withheld by the purchaser in the case where the acquisition value and the selling price are clear.
Amendments to the Foreign Investment Promotion Act

Effective from 1 January 2004, the revised regulations of the Foreign Investment Promotion Act (FIPA) provide cash grants as a new incentive for direct foreign investment in Korea. Cash grants shall be available for qualifying investments as follows:

- an investment worth US$10 million or more to establish a new or an additional factory (for manufacturing businesses) or business place (for non-manufacturing businesses);
- an investment worth US$10 million or more to build a new factory or expand an existing factory in certain parts and materials industries as set forth in the enforcement decree of the FIPA; or
- an investment worth US$5 million or more to build new or additional research and development (R&D) centres which should respectively have at least 20 full time technical staff having master degrees and three-year experience in R&D activities.

According to the revised rules, a foreign investor is restricted from spending cash grants received for purposes other than those set forth by the rules as follows:

- Expenditure to lease or purchase land to build a factory or a R&D centre;
- Expenditure to build a factory or a R&D centre;
- Expenditure to purchase capital goods (or research facilities) to be used in a factory (or a R&D centre) for business (or R&D) purposes;
- Expenditure to install electricity, communications and other infrastructure facilities of a factory or a R&D centre; or
- Employment subsidy and professional training subsidy.

In order to receive cash grants, a qualifying foreign investor must file an application for cash grants with the Ministry of Commerce, Industry and Energy (MOCIE) along with investment prospectus which should include investment amount and details, employment numbers, technology effect and contribution to local economy. The final decision on the authorisation of cash grants and grant amounts shall be made through consultations between the MOCIE and the Ministry of Planning and Budget.

The revised FIPA also provides an incentive to enhance the foreign investment environment. This incentive will be in the form of a reduction of up to 100% of the rental fee for the leasing of state-owned property to operate certain facilities to be exclusively used by foreigners including schools, hospitals, drug stores, housing, etc.

The revised regulations ease the criteria for foreign investment eligible for tax incentives in a foreign investment zone. Under the eased criteria, any foreign investment of US$30 million or more in the manufacturing business shall qualify for tax incentives in such zone. The previous investment threshold was US$50 million. The tax incentives include:

1. exemption from corporate or individual income taxes for the first five years and a 50% reduction for the next two consecutive years;
2. exemption from local taxes (including acquisition, registration, property and aggregate land taxes) for the first five years and 50% reduction for the next two consecutive years; and
3. exemption from customs duties, value added tax and special excise tax on imported capital goods for the first three years.

In addition, the revised regulations of the FIPA introduce a project manager system whereby a designated project manager would provide a specific foreign investor or foreign investment company in Korea with administrative assistance. Such project manager shall be appointed by the CEO of the state-run Korea Trade Investment Promotion Agency (KOTRA).
OTHER CHANGES

Record-keeping Requirements for “Excessive” Entertainment Expenses

A new provision is enacted to provide a legal basis to impose the record-keeping requirements on corporations for the payment of entertainment expenses in excess of specified limits. Entertainment expenses refer to expenses paid by a corporation in connection with its business activity and are deductible with certain limits.

Based on the new provision, the Korean National Tax Service (NTS) issued a notice on 5 January 2004 on new substantiation rules for entertainment expenses in excess of the limits determined by the NTS Commissioner. The latest notice sets out the limit and the new record keeping requirements that apply to each item of entertainment expenditure in excess of 500,000 Korean won, incurred from the year of income commencing on or after 1 January 2004.

Under the NTS notice, the following information must be recorded and maintained for each item of entertainment expenditure to substantiate that the relevant expenditure is business related:

- Purpose of entertainment;
- Name of the person and division providing the entertainment; and
- Name of the person receiving the entertainment, including the name of the division, company and business registration number (or name and national identification number for non-business individual).

The above information can be recorded on the back of the relevant credit card voucher, tax invoice or invoice, any sheet attaching such records or on a separate “entertainment schedule”.

For the purpose of determining the W500,000 limit for each item of entertainment expenditure, there are anti-avoidance rules to counter “splitting” of expenditure to fall below the limit where the expenditures in substance relate to a single transaction.

Deductibility of Intra-group Service Fee

In its recent ruling (Jaekukjo-77, 2003.11.11), the Ministry of Finance and Economy (MOFE) held that a Korean subsidiary in a multinational group may claim a deduction for intra-group service fee paid to a foreign related company, provided that the costs allocation method is reasonable and the mark-up is on an arm’s length basis.

In the ruling, the taxpayer enquired whether a fee paid to a foreign group service company for the provision of marketing, accounting, legal, finance, IT and R&D services was deductible. The service fee was payable pursuant to a common cost sharing agreement which allocated costs incurred by the group service company to each company in the group based on revenue at a predetermined mark-up.

The ruling is a welcome clarification for many multinational companies where provision of intra-group services through a group service centre is a common practice.

The ruling reaffirms the Supreme Court decision (2001 Du 3167, 2002.9.27) which held that management service fees, calculated based on a reasonable allocation of common costs, payable by a Korean company to a foreign related company are deductible.

It is also currently proposed that the Enforcement Decree to the Corporate Income Tax Act be amended to specifically include a provision to generally allow a deduction for management service fees, although detailed rules are not yet available.

The Korean tax authorities now seem to acknowledge that administration and management support services provided to a Korean subsidiary of a multinational group are reasonably related to the income earning activities of the Korean subsidiary, and thus a fee paid for such services should generally be deductible under the general deduction provision. However, where the service fee is based on a “cost-plus” method, such mark-up will need to satisfy the arm’s length test to be deductible.
A comprehensive avoidance of double taxation agreement (DTA) was entered into between the Macau Special Administrative Region (SAR) and the PRC government on 27 December 2003. The following are some of the features of the DTA:

- Withholding tax rate on dividends, interest and royalties is 10%. There is also a reduced withholding tax rate of 7% on interest to banks and financial institutions.

- Gains arising from the alienation of shares representing a participation of not more than 25% of the shares in a non-real property company which is a resident of one contracting side will only be taxable in the side in which the alienator is a resident. In other words, there is an exemption in the investee country for gains arising from the sale of portfolio investments situated in that country.

- There is no “limitation of benefits” article in the DTA.

- The DTA also covers business profits, income from dependent and independent personal services, income of artists or athletes, teachers, researchers, students and apprentices, as well as income for government services.

The Macau SAR has also entered into a Closer Economic Partnership Arrangement (CEPA) with the PRC government on 17 October 2003 which came into effect on 1 January 2004. The content of the Macau SAR / PRC CEPA is similar to the CEPA between the Hong Kong SAR and the PRC government, except that certain zero-tariff items under the Macau CEPA are not covered under the Hong Kong CEPA.
The global SARS epidemic in early 2003, coming hard on the heels of the Iraq War, had significant detrimental effect on certain sectors of the economy. To counter the negative impact of these events, measures to stimulate the economy were announced in May 2003 under a special “Economic Stimulus Package.” Whilst a number of tax measures proposed under the Package were aimed at promoting private investment as well as developing new sources of growth in the economy, focusing particularly on local small and medium sized enterprises (SMEs), there were also other measures to enhance the nation’s competitiveness as a destination for foreign direct investments.

Liberalisation of Foreign Equity Participation
An important announcement made under the Package was the move to liberalise the Foreign Investment Committee (FIC) Guidelines to provide greater flexibility on foreign equity participation in local companies. Some of the changes are:

- For acquisitions by foreign interests, the only equity condition imposed is Bumiputra (indigenous Malaysians) equity of at least 30%. The remaining equity can be held either by foreign interests or jointly by foreign and Malaysian interests.

- The threshold level for acquisitions by foreign and Malaysian interests, which is exempted from FIC’s approval, is raised from RM5 million to RM10 million.

- Proposals on acquisitions by companies would be processed either by the Ministry of International Trade and Industry or the Securities Commission. Consideration by the FIC is no longer required.

- Foreign equity condition for companies seeking listing on the Kuala Lumpur Stock Exchange (KLSE) would be liberalised to attract more foreign companies to list on the Exchange.

- Greater flexibility would be accorded in respect of the timeline for compliance with equity conditions (by way of extension of time or waiver of equity conditions for companies incurring losses).

- Foreign interests would be allowed to acquire landed properties costing more than RM150,000 per unit.

- For acquisitions exceeding RM100 million, application can be made for exemption from FIC Guidelines, subject to approval by the Minister of Finance. The application must be made before 31 May 2004.

These measures demonstrate the Malaysian government’s readiness to develop a truly business-friendly environment for foreign investors in Malaysia. The government has also given assurance that every effort would be made to ensure their effective implementation by close and continual monitoring.

2004 BUDGET
Further measures to stimulate and strengthen the Malaysian economy were announced in the 2004 Budget, which was presented by the Finance Minister in September 2003. The Budget adopted two main strategies for growth - to develop the private sector as the engine of economic growth, and to promote Malaysian industries in the global market.

Tax Incentives
Some of the general incentives proposed under the Economic Stimulus Package and the 2004 Budget are highlighted below:

- The threshold of chargeable income which is taxed at the reduced rate of 20% for small and medium scale companies would be increased from RM100,000 to RM500,000 from the year 2004. The normal corporate tax rate is 28%.

- Pioneer incentive and investment tax allowance (ITA) for small companies is enhanced. Income tax exemption under pioneer incentive is increased from 70% to 100% and statutory income against which ITA can be deducted is increased from 70% to 100%. Also, a Pioneer Status company which intends to undertake reinvestment before expiry of its pioneer status may opt for Reinvestment Allowance (RA), provided it surrenders its pioneer status.

- A company granted “Strategic Knowledge-based Status” would be granted tax exemption on 100% of statutory income for 5 years under the Pioneer incentive, or ITA of 60% of qualifying capital expenditure incurred over 5 years, to be deducted against 100% of statutory income.
Malaysia

• Companies that qualify as International Procurement Centres, where turnover exceeds RM100 million, would enjoy income tax exemption for 10 years.

• Income from qualifying services provided by an approved Operational Headquarters company to its related companies in Malaysia would be given tax exemption provided that such income does not exceed 20% of the OHQ’s income from qualifying services.

• Group relief which is currently available only to companies investing in subsidiaries engaged in certain approved food projects or deep sea fishing, is extended to companies engaged in forest plantations, including rubber plantations and for selected products in the manufacturing sector.

• To reduce the cost of doing business, incorporation expenses such as registration fees and expenses incurred in preparing the memorandum of incorporation would be allowed as a deduction for companies with authorised share capital not exceeding RM2.5 million (increased from RM250,000). Other measures for this purpose include the granting of double deduction for
  - expenses on leave passage for domestic travel provided for employees incurred during a period of one year from 1 June 2003;
  - salaries paid for 2 years to hire graduates registered with the Economic Planning Unit of the Prime Minister’s Department.

Personal Tax
In the area of personal tax, an important development is the granting of exemption from income tax (effective from the year 2004) on income remitted to Malaysia by any person other than a company, such as a resident individual, a trust body, a cooperative and a Hindu joint family.

Real Property Gains Tax (RPGT)
One significant tax measure proposed under the Economic Stimulus Package is the exemption from RPGT on gains arising from the disposal of real property within a period of one year, commencing from 1 June 2003. The exemption applies to all properties (residential and commercial) and extends to individual as well as corporate disposers.

FURTHER LIBERALISATION OF FOREIGN EXCHANGE ADMINISTRATION RULES
The Central Bank of Malaysia has announced new rules (to take effect from 1 April 2004) which are aimed at further liberalising foreign exchange controls. Among the changes are the following:

• The requirement for exporters to submit annual and quarterly reports for export of goods is abolished except for exporters with annual gross exports exceeding RM50 million, who are still required to submit quarterly reports.

• The overnight limits of foreign currency accounts (FCA) are increased for Malaysian companies as well as individuals. The overnight limits for export FCA of resident exporters are increased to between USD30 million and USD100 million based on the amount of exports, from the previous limits of between USD3 million and USD70 million. Resident individuals are allowed to open FCA for overseas education and employment. For them, the aggregate overnight limit for accounts with onshore licensed banks and licensed offshore banks in Labuan is increased from USD100,000 to USD150,000.
  Other rules on opening of non-export FCA are also further relaxed. For example, companies with domestic borrowing were previously allowed to open FCA with licensed Malaysian banks subject to an overnight limit of USD 500,000; the new rules now allow companies with or without domestic borrowings to open such accounts with onshore licensed banks with no overnight limit.

• The limits for non-residents to borrow in ringgit from domestic financial institutions are relaxed and simplified. One relaxation relates to previously stipulated ringgit lending limits for various specified purposes by banking institutions to a non-resident (excluding certain financial institutions). These are now consolidated into one aggregate limit and raised to RM10 million. The non-resident may use the ringgit credit facilities for any purpose in Malaysia, except for financing or refinancing of acquisition of immovable properties.
To provide greater flexibility in the management of funds, selected domestic institutions and residents are allowed to invest abroad within a broadly defined framework. The framework sets limits on the amount that may be invested abroad by unit trust management companies, insurance companies, and fund/asset managers as well as stipulates compliance with guidelines issued by the relevant supervisory authority for each type of establishment.

Other changes relate to rules that apply to transactions involving forward foreign exchange contracts entered into by residents of Malaysia as well as issuance of ringgit-denominated bonds by selected non-residents. Details of all changes are available from the website of the Central Bank of Malaysia at www.bnm.gov.my.

INDIRECT TAX

Some significant developments in this area are:

• The announcement of a new import and excise duties structure for cars on 31 December 2003, which was gazetted as law on 1 January 2004. Excise duties are only imposed on Completely Built Up (CBU) motor vehicles and range from 30% to 100%. The range of import duties for CBU cars is from 60% to 200%. The clear impact of the new structure has yet to emerge, although it would appear that the hope-for reduction of prices for Association of Southeast Asian Nations (ASEAN) origin cars is not likely to materialise.

• The ASEAN Harmonized Tariff Nomenclature (AHTN) was implemented by Malaysia on 1 January 2004. The AHTN harmonizes the customs classification of all goods (to 8 digits instead of the usual 9 digits) traded among the 10 ASEAN countries. Malaysian importers and exporters must use the 8-digit AHTN tariff codes when importing from and exporting to other ASEAN countries.

• On 1 January 2004, Malaysia effectively transferred tobacco and tobacco products into the “Inclusion List” of the ASEAN Free Trade Area (AFTA) Common Effective Preferential Tariff (CEPT) Scheme to enable these goods to attract preferential rates of import duties on their importation into Malaysia, provided they are accompanied by a certificate of ASEAN origin.

NEW LEADERSHIP

The Prime Ministership of Malaysia was taken over by Dato Seri Abdullah Ahmad Badawi from Tun Dr. Mahathir bin Mohamad, in a smooth transition of power on 31 October 2003. Malaysia held its eleventh General Election on 21 March 2004, in which Dato Seri Abdullah’s party won a decisive victory, and was returned to power in all but one of the 13 states of Malaysia.

Dato Seri Abdullah has also assumed the cabinet position of Finance Minister.

The new Prime Minister has pledged to continue with all existing government policies affecting businesses and investments, and has given assurance that the government remains committed in its efforts to create a business-friendly and attractive environment for entrepreneurs (whether local or foreign).
NEW ZEALAND

INTERNATIONAL RECRUITMENT

A Government discussion document, released in November 2003, outlines proposals aimed at ensuring New Zealand's tax system does not discourage the recruitment of overseas employees. If implemented, the proposals will exempt the foreign sourced income of certain migrants and returning New Zealanders from New Zealand's comprehensive international tax regime. The intention is to limit the degree to which tax influences a migrant's decision whether to accept employment in New Zealand.

The Government has called for submissions on the relative merits of two possible approaches. They are targeted at employees and not at high wealth individuals or retired people wishing to settle in New Zealand. Legislation is unlikely to be effective before 2005.

FOREIGN DIRECT INVESTMENT

The Minister of Revenue has confirmed that the Government will not introduce a reduced effective rate of income tax on new foreign direct investment. In its 2001 report the McLeod Tax Review Committee recommended reducing the company tax rate for foreigners to 18% and reducing the non-resident withholding tax rate on dividends to 2%. Officials subsequently recommended rejection of the recommendations on the basis that they would result in significant revenue loss that would not be offset by a sufficient increase in new foreign direct investment.

GOODS AND SERVICES TAX ON IMPORTED AND FINANCIAL SERVICES

Two significant changes to goods and services tax (GST) were introduced in an Act passed in November 2003:

- a “reverse charge” mechanism that requires the self-assessment of GST on the value of services imported by registered persons. The reverse charge applies to imported services that are acquired for purposes other than making taxable supplies and that would have been subject to GST if they had been provided in New Zealand.

- the zero-rating of financial services supplied to other registered businesses. This enables financial institutions to recover more GST as input tax credits than was possible previously.

The changes will come into effect in 2005.

NON-RESIDENT CONTRACTORS

With effect from 1 December 2003, the grace period for which certain non-resident contractors can conduct a contract activity in New Zealand without non-resident contractors' withholding tax (NRCWT) being withheld has been extended to 92 days. The non-resident contractor must be eligible for relief under a double tax agreement. Non-resident contractors present in New Zealand for more than 92 days need to apply for certificates of exemption from NRCWT if they wish to avoid having NRCWT withheld at source.

A further change will exempt payments for contract work amounting to less than NZ$15,000 in a 12-month period from NRCWT. In such cases contractors themselves will be responsible for paying any New Zealand tax owing at the end of the year.

TRANS-TASMAN TAX

The New Zealand and Australian Governments introduced a solution to the trans-Tasman triangular tax issue in 2003. Triangular taxation occurs where New Zealand shareholders in an Australian company operating in New Zealand are unable to access New Zealand sourced imputation credits, resulting in double taxation for the New Zealand shareholder. The same problem applies in reverse for Australian shareholders in New Zealand companies operating in Australia.

The Act passed in New Zealand in November 2003 introduced a pro-rata allocation mechanism that enables companies to assign credits to shareholders for tax paid in each of the countries (i.e. imputation credits for New Zealand tax paid and franking credits for Australian tax paid). The new rules apply to distributions made after 1 October 2003. Under pro-rata allocation, dividends paid by an Australian resident company with a New Zealand resident subsidiary (and vice versa) will have both franking and imputation credits attached in proportion to the shareholding of the recipient.
The benefit to an investor from the reforms depends on the dividend distribution policy of the distributing company and the percentage of income derived by that company from the investor’s home jurisdiction. The rules apply to chains of New Zealand and Australian companies irrespective of levels of ownership.

The new rules do not completely eliminate double taxation. This is because New Zealand shareholders are able to use only imputation credits and Australian shareholders are able to use only franking credits to reduce the tax liability in their respective home jurisdictions.

**TAXATION OF OFFSHORE PORTFOLIO INVESTMENT**

The Tax Review 2001 suggested that New Zealand’s foreign investment fund (FIF) rules be reformed and that all foreign portfolio investments (i.e., less than 10% holdings) held by New Zealand residents be taxed using a risk free rate of return method (RFRM). The RFRM taxes a notional inflation adjusted amount that would arise if the funds invested had instead been put into a risk free investment.

In December 2003, officials released an issues paper which canvasses two options for changing the taxation of foreign portfolio investments. The options would also apply to life insurance policies and superannuation funds.

The first option is a variation on the RFRM called the “standard return rule”, under which taxable income would be calculated by applying a statutory deemed rate of return (4%) to the opening value of an investment. The second more radical option envisages a set of rules that would apply to all offshore portfolio investment irrespective of the country of investment or type of investor.

Under both options the distinction made under the FIF rules between so-called “grey list” and “non-grey” list investments would be removed. Currently, for equity investments in the seven grey list countries (Australia, UK, USA, Canada, Japan, Germany and Norway), only dividends and revenue account realised gains are taxed. By contrast, equity investments in non-grey list countries are taxed on an accrual basis.

In 2003 the Government also made it clear that it intends to target New Zealand investors using overseas funds to escape New Zealand tax. It is particularly concerned about Australian unit trusts that invest in New Zealand government stock and offer associated investment products that are free of New Zealand income tax. A similar investment via a New Zealand unit trust would be subject to tax.

**TAX SIMPLIFICATION**

In September 2003 the Government proposed a new tax payment regime, which, if implemented, will change the frequency and timing of provisional tax payments. Proposals issued under the banner “Making tax easier for small businesses” include:

- standardising the due date for both GST and provisional tax payments to the 28th of the month for all taxpayers;
- changing the frequency of provisional tax payment dates to either twice or six times a year (from the current three times a year) depending on the category of taxpayer; and
- allowing smaller businesses to calculate provisional tax payments on a percentage of GST sales.

Any proposals that are to proceed are likely to be included in a tax bill in 2004 but are unlikely to come into effect before 2005.

**FRINGE BENEFIT TAX REVIEW**

The Government issued a discussion document, “Streamlining the taxation of fringe benefits” (the discussion document) in December 2003. The discussion document outlines proposals to change the fringe benefits tax (FBT) treatment of motor vehicles - including the options available to employers for valuing vehicles provided to employees, the treatment of leased vehicles and the requirements for work-related vehicles. Other proposals include widening the FBT net in respect of car parks provided by employers and increasing the de minimis levels for other benefits to more commercially realistic levels.

Submissions on the proposals closed in February 2004. Any changes are likely to be included in a tax bill in 2004 but are not expected to come into effect until 2005.
LOSS OFFSETS
The Inland Revenue Department (IRD) has issued its draft policy on loss offsets between group companies. The different interpretations of the loss-offset rules have led to a variety of practices being adopted by taxpayers. The draft policy’s stated aim is to clarify the interpretation of the legislation and outline acceptable practices for loss offset elections. It states that the Commissioner will not accept formula based elections (that do not specify a loss amount but instead state that the loss offset will be of the portion of the loss making company’s loss that will reduce the profitable company’s taxable income to nil).

MASS MARKETED TAX SCHEMES
Legislation designed to combat mass marketed tax schemes was passed in November 2003. It targets schemes enabling investors to generate greater tax deductions than the amount of money invested, particularly where the deductions occur regardless of the success of the scheme. The new “deferred deduction” rule defers an investor’s entitlement to a deduction for losses from a scheme to the extent that the losses exceed the amount of money that the investor has put at risk.

KYOTO PROTOCOL
New Zealand ratified the Kyoto Protocol on climate change on 10 December 2002, thereby committing to reductions in greenhouse gas emissions from 2008. Despite Russia’s failure to ratify the Protocol to date (and without Russia’s ratification the Protocol commitments will not become binding) the New Zealand Government seems set on introducing an emissions charge capped at NZS25 per tonne of carbon dioxide equivalent in 2007. The Government has retained the option of introducing emissions trading as an alternative to the emissions charge. The agricultural sector is to be exempt from the charge at least until 2012 provided it invests in research on reducing agricultural emissions.

The Government is currently entering into Negotiated Greenhouse Agreements with affected entities.

ASSET TRANSFERS ON DEATH
In April 2003 the IRD and Treasury released an issues paper entitled “Tax implications of certain asset transfers” which suggests ways of clarifying the income tax treatment of non-monetary (i.e. in-kind or in specie) distributions by companies and trusts, gifts of assets by individuals and various asset transfers that occur on the death of a taxpayer. While the current tax treatment is clear for some of these transfers, in most situations the value to be assigned to the transfer is not. The paper recommends the adoption of generic rules that would treat these types of asset transfers as dispositions and acquisitions at market value. Officials are not suggesting any change to the treatment of assets currently outside the tax base (e.g. where an asset is held on capital account).

CHARTITIES
The New Zealand Government is continuing to address the tax treatment and accountability of charities and non-profit organisations. A new Bill introducing a Charities Commission was introduced into Parliament in late March 2004. The Government intends to have the Bill passed in late 2004 and registrations are likely to be invited from mid-2005. Although registration with the Commission will be voluntary, charities wishing to obtain tax-exempt status will be required to register.

TAX BILL INTRODUCED
The Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill was introduced into Parliament on 29 March 2004 and is expected to be passed before the end of 2004. The Bill contains the following significant proposals.

Venture Capital and Special Partnerships
In a positive move, the Bill proposes removal of a tax barrier that has made it difficult for some New Zealand unlisted companies to gain access to offshore venture capital. The changes, which are intended to apply from 1 April 2004, will benefit non-residents who invest in New Zealand and are currently subject to tax in New Zealand on share sale transactions that are not taxable in their home countries. To qualify for the exemption, the non-residents will have to be exempt from tax in their own jurisdictions. Residents of the majority of countries with which New Zealand has a double tax agreement will be eligible.

The Government is also proposing to align the New Zealand tax treatment of limited liability partnerships with the Australian treatment of such partnerships. This change will involve repealing the current provisions that prevent resident (but not non-resident) special partners from offsetting losses against other income.
Resource Management Consent Applications and Patent Expenditure

The Bill proposes that costs associated with patent and resource management consent applications that are not granted or are withdrawn be treated as deductible for income tax purposes. This is a positive development as currently expenditure incurred in applying for a patent or resource management consent that results in an application not being granted must be capitalised and depreciated. The amendment will apply from the 2004-2005 income year for applications that are not granted or are withdrawn in that year or a subsequent income year.

Changes to Tax Leasing Rules

The Bill proposes changing the tax treatment of certain transactions, targeting those involving the sale and leaseback of intangible property (IP) such as trademarks. The Government considers that certain types of transaction are in substitution for a loan and the overall effect is to allow a deduction for repayments of principal as well as the related interest.

The intended effect of the proposed amendments is to recharacterise certain sale and leaseback transactions involving IP for tax purposes as a transfer of the IP to the licensee, accompanied by a loan, for which an interest only deduction will be permitted under the timing regime prescribed by the accrual rules. No depreciation deduction will arise unless the asset is a depreciable intangible property. Trademark ownership rights are not depreciable intangible property rights.

The Bill amends the finance lease rules that apply to transactions entered into on or after 29 March 2004, the date of introduction of the Bill. There are concerns that the changes are not restricted to leases of IP and submissions are being made to have more targeted changes.

Disputes

The Bill also amends several of the rules that govern the resolution of disputes between taxpayers and the IRD. Specific areas amended include the requirement to complete the disputes process, details required in documentation, time bar waiver period, timeframes for tax refunds and GST input tax deductions, and the definition of exceptional circumstances. Generally the amendments will apply to disputes that commence on or after 1 April 2005.

Tax Discount in First Year of Business

The Bill introduces a 6.7% tax rebate for individuals who begin receiving self-employed or partnership income and make voluntary tax payments in the year before they are required to pay provisional tax for the first time. Individuals will be able to choose whether to receive the rebate in their first year of business or in a subsequent income year, but must claim the rebate before they begin paying provisional tax.

The rebate will be introduced with effect from the income year commencing from 1 April 2005.

Rewrite of the Tax Act

The Income Tax Bill 2002, commonly referred to as the “Rewrite”, received its third reading in Parliament on 8 April 2004 but had not yet been enacted at the date of writing.

The Bill is the third stage of a project to review and rewrite the Income Tax Act 1994 (1994 Act) in plain English. The Government’s key objective in rewriting the 1994 Act is to make the legislation clear and easy to read without generally changing the content of the current legislation. The Bill rewrites the “gross income”, “allowable deductions” and “timing of gross income and allowable deductions” parts of the Act.

Many of the intended changes in law or policy have already been signaled. These include the widening of the definition of “dividend”, and the rewrite of Division 2 of the accrual rules (which applies to financial arrangements entered into after 20 May 1999). Other changes in policy or law include changes in relation to employment, farming, livestock and forestry, films, land transactions, mining, international investment, insurance and superannuation, and trading stock.

The new Act will apply to income derived in the 2005-2006 and later tax years. For most taxpayers, the application date will be 1 April 2005. However, for taxpayers with early balance dates, the Act will apply from as early as 1 October 2004.
NEW TAX LEGISLATIONS

With the Philippine presidential elections forthcoming in May 2004, Congress stepped up its legislative output towards the end of 2003. The consequence is that several new laws, dealing both directly and indirectly with tax issues, took effect in early 2004.

Documentary stamp tax (DST)

Republic Act (RA) 9243, rationalizing the DST rules, took effect from 21 March 2004. The DST rates were reduced from 1% to 0.5% of par value for the issue of new shares, and from 0.75% to 0.375% of par value for the sale or exchange of existing shares. DST on insurance policies is now more sensibly levied on the amount of premium, rather than the amount of policy coverage. The rate of DST on debt instruments has generally increased from 0.15% to 0.5%, although recent court decisions support the view that this DST might be avoided if a loan or advance is not supported by formal documentation.

The RA also introduces explicit DST exemptions for derivatives, the transfer of property in the context of a tax-free exchange, and the sale of shares for the next five years in companies listed and traded through the local stock exchange.

Expanded jurisdiction of Court of Tax Appeals (CTA)

RA 9282 expanded the jurisdiction of the CTA, most notably to include criminal matters arising under the Philippine tax laws.

The RA also elevated the CTA to the same level as the Court of Appeals. The move appears to be in response to concerns that the judicial appeal process for tax cases was too slow, and that inconsistencies in decisions handed down by different circuits of the Court of Appeals created confusion over interpretation of the law. The CTA has been divided into two divisions. Decisions of the CTA will be appealed to the CTA en banc, and may then be appealed directly to the Philippine Supreme Court.

Securitisation Act

RA 9267 provides a general legal and regulatory framework for the securitisation of financial assets in the Philippines. It provides for the formation of Special Purpose Entities (SPEs) and Secondary Mortgage Institutions (SMIs) which would acquire assets and issue asset-backed securities (ABS), the repayment of which depends on the cash flow generated by the assets.

Various incentives are offered by the new Act to encourage the formation of SPEs. Among the incentives are:

- The sale or transfer of assets to an SPE and the secondary transfer of ABS will be exempt from VAT and DST.
- SPEs and SMIs will not be subject to the gross receipts tax (GRT).
- The yield from ABS held by a tax-exempt investor, or from a low-cost or socialized housing-related ABS, will be exempt from income tax. Otherwise, the yield will be subject to 20% final withholding tax.

Excise Tax on Automobile

RA 9224, which took effect on 4 October 2003, was enacted to rationalise the excise tax on automobiles.

The old law left the definition of automobiles open to interpretation through the implementing regulations. The new law specifically provides that an “automobile shall mean any four- or more-wheeled motor vehicle regardless of seating capacity, which is propelled by gasoline, diesel, electricity or any other motive power.” The law expressly excludes buses, trucks, cargo vans, jeeps / jeepneys / jeepney substitutes, single cab chassis, and special purpose vehicles from the definition.
Further, while the Tax Code previously levied the ad valorem tax on automobiles according to engine displacement in cubic centimeters and usage of gasoline or diesel, RA 9224 now imposes the graduated excise tax rates according to the net manufacturer's price/importer's selling price (NMP/ISP).

The NMP/ISP refers to the price, net of excise and value-added taxes (VAT), at which the automobiles are sold by the manufacturer / assembler or importer (MAI) to the dealers, or to the public directly or through their sales agents, as reflected in the MAI's sworn statement duly filed with the Bureau of Internal Revenue (BIR), or in their sales invoices / official receipts, whichever is higher.

The tax rates range from as low as 2% (for NMP/ISP of up to PhP600,000) to as much as PhP512,000 + 60% of the value in excess of PhP2.1 million. A luxury car with an NMP/ISP of PhP3.5 million would be levied an excise tax amounting to PhP1.3 million, reflecting an effective tax rate of almost 40% of the price.

In the case of imported automobiles for personal use and not for resale, the tax imposed shall be based on the total landed value. Importation of more than one automobile by the same importer or the sale / transfer of an imported automobile within a 12-month period is considered an importation intended for resale. In such case, the tax imposed shall be based on the NMP/ISP as discussed above.

Exclusion of Bank Services and Some Professionals from VAT

The consolidated bill exempts banks and non-bank financial intermediaries (NFI) performing quasi-banking functions and other NFIs from the 10% VAT, but re-imposes the GRT effective from 1 January 2004 and lapsed into law on 5 February 2004 with the promulgation of RA 9238. President Gloria Macapagal-Arroyo chose neither to sign or veto the bill. Thus, the bill lapsed into law without the signature of the President, as provided for in Article VI of the 1987 Philippine Constitution.

The RA re-imposes the maximum 5% GRT rate for interest, commissions and discounts from lending activities as well as income from financial leasing derived from instruments with a maturity period of 5 years or less. If the term is more than 5 years, the GRT rate is 1%. Net trading gains on foreign currency, debt securities, derivatives and other similar instruments and all other items of gross income shall also be taxed at 5%. However, for dividends and equity shares in net income of subsidiaries of banks and NFIs performing quasi-banking functions, the rate is 0%.

The RA also exempts duly registered doctors and lawyers from VAT.

It is worth noting that the VAT on banks, NFIs and professionals actually only became effective on 1 January 2003.

Selected Amendments to the Withholding Tax Regulations

Income payments subject to creditable withholding tax (CWT)

A standard rate of 15% (previously 20%) CWT is now applicable on the gross professional and talent fees of the following individuals if their gross income for the current year exceeds PhP720,000 or 10% if the gross income does not exceed PhP720,000:

a. Professional practitioners including designers and all other profession requiring government licensure examinations and / or regulated by the Professional Regulations Commissions;
b. Entertainers, which now include lyricist and composers, professional athletes, media directors (and producers);
c. Insurance agents / adjusters;
d. Management and technical consultants;
e. Bookkeeping agents / agencies;
f. Other recipients of talent fees; or
g. Fees of directors who are not employees of the company paying such fees, whose duties are confined to attendance at or participation in board meetings.

Exemption for marginal income earners

Marginal income earners (self-employed individuals deriving gross sales / receipts not exceeding PhP100,000 during any 12-month period) are exempted from creditable withholding tax on payments made by hotels, restaurants, resorts, caterers, food processors, canneries, supermarkets, livestock, poultry, fish and marine product dealers, hardwares, factories, furniture shops and all other establishments.
Persons required to withhold tax

The obligation to withhold is imposed on the buyer-payer of income although the burden of tax is really on the seller-income earner. Hence, unjustifiable refusal of the latter to be subjected to withholding tax shall be a ground for the mandatory audit of his income tax liabilities (including withholding tax) upon the verified complaint of the buyer-payer.

The regulations include agents, employees or any person purchasing goods or services / paying for and on behalf of the withholding agents in the list of persons required to withhold the tax. The amendment also stated that such agents or employees should immediately issue the corresponding certificate of taxes withheld upon withholding the tax.


Use of US Dollar or Japanese Yen

Where the US Dollar or the Japanese Yen is the functional currency used by a company, the BIR has allowed the use of either currency in financial reporting under certain conditions. This means that the company, whose functional currency is either US dollar or Yen, shall record its transactions in its books of account and prepare its financial statements (FS) using the applicable foreign currency with a translation to Philippine pesos using the prescribed exchange rate. The entity shall then compute its income tax based on the US dollar / Yen FS using the prescribed exchange rates and prepare its tax returns and pay the taxes due in Philippine pesos.

With this new rule, the recording of artificial foreign exchange gains and losses is avoided since the functional currency of the company is likewise its reporting currency.

Tax Treaties

The Philippines has successfully entered into force the following tax treaties with four countries and has re-negotiated an existing one:

(1) Czech Republic (for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income) - Convention entered into force on 23 September 2003 upon the notification by the Philippines to the Czech Republic of the ratification of the Convention in the Philippines. Its provisions on taxes apply to income derived or accrued beginning from 1 January 2004.


(3) State of Bahrain (for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital) - Convention entered into force on 14 October 2003. Its provisions on taxes apply to income derived or accrued beginning from 1 January 2004;

(4) People’s Republic of Bangladesh (for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income) - Convention entered into force on 24 October 2003. Its provisions on taxes apply to income derived or accrued beginning from 1 January 2004 in the case of the Philippines and beginning from 1 July 2004 in the case of Bangladesh.

(5) Kingdom of Sweden (for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income) - Convention entered into force to 1 November 2003 (re-negotiated). Its provisions on taxes apply to income derived or accrued beginning from 1 January 2004.
2004 BUDGET CHANGES AND 2003 IN SNAPSHOT

Following the 2003 budget changes announced in February 2003, a number of circulars, guidelines and press statements were released by the relevant statutory bodies [e.g. Inland Revenue Authority of Singapore (IRAS), Economic Development Board (EDB), etc.] to provide further details. The legislative provisions of the changes were enacted in the Income Tax (Amendment) Act 2003 in December 2003. A number of detailed rules and regulations however are yet to be gazetted.

In addition, the 2004 Budget Speech was announced on 27 February 2004 where changes were mainly focused on incentives for the financial services sector and individual taxpayers.

In this issue, we will mainly focus on the major changes announced in the 2004 Budget with a summary of the 2003 changes attached at the end of this article for easy reference.

Corporate and Personal Tax Rates

The corporate tax rate is reduced to 20% from the year of assessment 2005, as affirmed by the Minister in his Budget Speech last year. Although the same promise was made in respect of the top marginal personal tax rate, the Minister has decided to defer the reduction for the time being due to the need to preserve tax revenues in light of increased spending commitments and the delay in the increase in the Goods and Services Tax (GST) rate (which was originally due to increase to 5% on 1 January 2003, but was subsequently deferred to 1 January 2004).

Exemption of Foreign-sourced Income for Singapore Resident Individuals

All foreign-sourced income received in Singapore by resident individuals will be exempt from tax with effect from year of assessment 2005. This move was recommended by the Economic Review Committee in 2002 to boost Singapore’s private wealth management industry. The IRAS has since confirmed that the exemption conditions for dividends and service fee income (incentive announced in the 2003 Budget) are now overridden as far as individuals are concerned.

The exemption however does not apply if the foreign-sourced income is received through a partnership in Singapore.

Exemption of Singapore-sourced Investment Income for Individuals

Given that the aim of the exemption of foreign-sourced income for individuals was to encourage them to remit their capital and thus stimulate the private wealth management industry in Singapore, it was inevitable that the income generated by that capital in Singapore also had to be exempted to a large extent.

Typically, there is a list of income that qualifies for the exemption. This is as follows:

(i) Interest from debt securities;

(ii) Discount income from debt securities, the tenure of which is 1 year or less;

(iii) Annuities (excluding those derived from an employer who purchased the annuity for him and is in lieu of pension or other benefits payable during employment or upon retirement);

(iv) All payments on life insurance policies, including interest from insurance benefits that have not been drawn and investment income on investment-linked policies (but excluding sums realised or interest from insurance benefits that have not been drawn under any insurance against loss of profits);

(v) Distributions from unit trusts and real estate investment trusts that are authorised under Section 286 of the Securities and Futures Act (excluding distributions out of franked dividends) to which unit holders are entitled from 1 January 2004 onwards; and

(vi) Borrowing fees, loan rebate fees, price differential and compensatory payments arising from securities lending and repurchase arrangements.

The interaction between this incentive and the foreign-sourced income incentive inevitably means that partnerships are also excluded.

The exemption will apply to both residents and non-residents. The inclusion of non-residents would appear to be in line with the Government’s desire to stimulate the wealth management industry.
Enterprise Investment Incentive

The Minister expanded the scope of the current Technopreneur Investment Incentive Scheme from high-tech businesses to all forms of start-up operations.

Essentially, investors in relevant companies will enjoy tax deductions for losses incurred if the company fails or is sold at a loss. This will help reduce the risks faced by venture capital providers in assisting new businesses get off the ground. The new scheme is known as the Enterprise Investment Incentive (EII).


Financial Services Incentives

Qualifying debt securities (QDS)

To encourage further development of the short-term debt markets, it is now proposed that discount income (excluding that arising from secondary trading) in relation to QDS, the tenure of which is 1 year or less, be accorded the same treatment as that applicable to interest under the QDS regime. This expanded scope applies to QDS issued from 27 February 2004 to 31 December 2008.

Wealth management incentives

Enhancements to the tax exemption scheme for foreign investors and foreign trusts

It is proposed that the scope of specified income qualifying for this exemption be expanded. In turn, this would give fund managers wider discretion to invest in new classes of instrument on behalf of these foreign investors without exposing them to Singapore tax.

With effect from 27 February 2004, the designated investments of foreign investors are expanded to include the following:

- QDS (including discount instruments issued from 27 February 2004 to 31 December 2008 with not more than 1 year tenure); and
- securities (excluding stocks and shares) issued by supranational bodies,
while specified income is expanded to include:

- the following income which is received in Singapore:
  - income from immovable property located outside Singapore;
  - overseas debt securities’ discount income;
  - foreign unit trust distributions from outside Singapore;
- fees and compensatory payments from securities lending and repurchase arrangements (REPO); and
- QDS interest and discount income (for QDS issued from 27 February 2004 to 31 December 2008 with not more than 1 year tenure).

In addition, the tax exemption for foreign trusts is expanded to include the above designated investment income, overseas debt securities and REPO fees and compensatory payments.

**Enhancement to Designated Unit Trust (DUT) scheme**

In recognition of the fact that the nature of investments by funds has expanded beyond the scope of traditional securities, and that funds do deal in foreign exchange and derivative transactions in order to enhance their yield or to protect their capital, it is proposed that income derived from these transactions also be exempted from tax at the trust level, where the trust is a DUT.

Distributions of the following income (derived or received from 27 February 2004 onwards) will not be taxed at the trust level and will be exempt from tax in the hands of individual unit holders who are not traders in securities:

- the expanded scope of specified income (see above);
- gains from disposal of securities issued by supranational bodies; and
- income from foreign exchange and derivatives transactions.

Please refer to the Monetary Authority of Singapore (MAS) circular dated 2 March 2004 for more details.

**Asset Securitisation**

The various sources of tax leakage in a securitisation transaction could include tax on the transfer of assets into a special purpose vehicle (SPV), withholding taxes on interest payments to bond holders, and taxation of the SPV itself. While the issue of withholding tax has been addressed by the QDS regime, there is a risk that the SPV could be subject to significant taxation if there is no proper matching of income and expenses for taxation purposes. To promote certainty in this respect, it is proposed that a special tax regime be accorded to SPVs used in securitisations. Although details of the regime have not been announced, it is widely expected that flow-through treatment will be conferred at the SPV level so as to preserve tax neutrality.

**Withholding Tax Exemption for Payments on Over-the-counter (OTC) Financial Derivatives**

Although it is doubtful if payments under such contracts constitute payments in connection with indebtedness in the first place, given that these are typically notional principal contracts, the introduction of exemptions would provide the certainty in treatment that the financial markets have demanded.

In this regard, interest and currency swap payments by financial institutions to non-residents (other than permanent establishments in Singapore) are already exempt from withholding tax. To enjoy a withholding tax exemption for payments under other types of financial derivatives, financial institutions would need to apply for the Financial Sector Incentive (Derivatives Markets) award, for which they would need to have at least 6 professional staff in Singapore covering origination, structuring and trading activities.

It is proposed that the withholding tax exemption for payments on OTC financial derivatives be now extended to all financial institutions. However, the scheme is only applicable to payments on qualifying derivatives from 27 February 2004 to 19 May 2007.

The current compliance requirement for related party transactions of submitting a letter of undertaking confirming that transactions were carried out at arm’s length will similarly apply.
Commodity Derivatives Trading
Currently, banks and companies approved under the global trader programme (GTP) or approved oil trader (AOT) scheme enjoy a concessionary tax rate of 5% or 10% on income from commodity derivatives. In the case of the companies under the GTP and AOT scheme, the OTC derivative trades must be done in connection with hedging physical trading before the concessionary treatment applies.

Although these incentives work reasonably well for companies in the petroleum industry, they are not truly designed with non-bank financial institutions acting as market makers in mind. In addition, income from certain futures trading derived by GTPs or AOTs from trades with banks could qualify for the 5% or 10% tax concession. However, banks which trade with GTPs or AOTs do not enjoy the same treatment under existing regulations. Even with the removal of the counter-party or currency restrictions under the Financial Sector Incentive, asymmetry persists because of the need to apply the Qualifying Base calculation.

Therefore, a new commodity derivatives trading is introduced where qualifying financial institutions and companies can be granted a 5% tax rate (for period not exceeding 5 years) on qualifying derivatives trading transactions in any currency with qualifying counterparties.

Please refer to the MAS circular dated 19 April 2004 for more details.

Processing Services Provided to Financial Institutions
The development of Singapore as a processing centre is integral to the various initiatives in positioning Singapore as a global business hub. Hence it is proposed that a 5% concessionary tax rate be applied to income derived by companies providing qualifying services to financial institutions approved from 27 February 2004 to 26 February 2009. Further details will be announced in May 2004.

Details of the rest of the 2004 Budget changes are featured at our PwCTax.com website. For more details, visit our website at http://www.pwc.com/extweb/pwcpublications.nsf/docid/8F6039FF6AA880D8CA256D82000D83C1

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<tr>
<th>January</th>
<th>Headquarters Incentive</th>
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<td></td>
<td>The EDB released details of a new enhanced headquarters programme to replace the existing Operational Headquarters (OHQ) incentive. The new programme consists of:</td>
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<td>• a simplified Regional Headquarters Award where a preferential tax rate of 15% will be applicable for the first 3 years; and</td>
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<td>• an International Headquarters Award where preferential tax rates could range from 0% to 10%, and covers a wider range of service and trading activities.</td>
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<th>February</th>
<th>Financial Sector Incentive (FSI) Scheme</th>
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<td></td>
<td>Details of the final phase of the development of the financial sector's incentives were released. Mainly on the streamlining and consolidation of the various tax incentives into a single concept known as the FSI Scheme.</td>
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<td></td>
<td>• Extension of due date to 15th of month following date of payment</td>
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<td></td>
<td>• Deemed payment is date of invoice in the absence of an agreement to the contrary.</td>
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<td>Deadline for election for tax to be withheld at 22% on net income is extended to 45 days from 30 days from 1 April 2003 and concession for multiple payments under a single engagement is introduced.</td>
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<td>April</td>
<td>Integrated Industrial Capital Allowance (IICA) Incentive</td>
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<td>Receipts</td>
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### August

| Simplification of Procedures | The IRAS simplified certain income tax rules and procedures for companies, covering:  
|                            | • application to pay normal (tax incentive) exempt dividends before the income is assessed;  
|                            | • application for waiver of shareholders’ shareholding test; and  
|                            | • waiver of withholding tax requirement on interest paid to non-resident branches which are not banks.  
| Audit Exemption             | In view of the audit exemption under the Companies Act, the IRAS issues guidelines on the income tax filing requirements for companies affected by the exemption. |

### September

| Public Sculptures Donation Scheme | The National Heritage Board released guidelines on the public sculpture donation scheme. |
| Portable Medical Benefits        | The MOM releases details of the new portable medical benefit schemes, i.e. the Portable Medical Benefits Scheme (PMBS) and Transferable Medical Insurance Scheme (TMIS). |

### October

| Overseas Investment Incentive | IE Singapore finally released details of the revised Overseas Investment Incentive scheme which are effective from 1 January 2004 and replaces the existing scheme. |
| Writing Down Allowances (WDA) for Intellectual Property | The EDB released details for auto-WDA for Intellectual Property. |
| Statutory Declaration for Real Property Transactions | The IRAS removed the need to make a statutory declaration for real property transactions. |

### November

<p>| Foreign Exchange Differences | The IRAS announced the new tax treatment where corporate entities are now allowed to deal with their foreign exchange differences for tax in the same way that banks have been allowed to since 1993. |
| Designated Unit Trust (DUT)  | The MAS issued a circular to fine-tune an earlier qualifying condition for the DUT scheme which allows capital-protected and capital-guaranteed funds the status. |
| Hire-Purchase &amp; Other Financing Arrangements | The IRAS issued a circular which sets out the rules for the GST treatment of hire-purchase and other financing arrangements under the expanded gross margin scheme. |</p>
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<th>December</th>
<th>Non-Singapore Dollar Functional Currency</th>
<th>The IRAS issued a circular on the filing requirements for companies with non-Singapore dollar functional currency. The new procedures takes effect for companies with accounting periods beginning on or after 1 January 2003.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Income Tax Act</td>
<td>The Income Tax (Amendment) Act 2003 was enacted. No surprises.</td>
</tr>
<tr>
<td></td>
<td>Taxpayer Audit</td>
<td>The Income Tax Act (Revised Edition 2004) was published. Full of surprises.</td>
</tr>
<tr>
<td></td>
<td>Goods and Services Tax</td>
<td>The IRAS issued a circular on taxpayer audit which formalises and clarifies the conduct and process of an IRAS audit.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The IRAS released guidelines on transitional measures for the GST increase to 5% from 1 January 2004.</td>
</tr>
</tbody>
</table>

For more details, visit our Singapore tax website at http://www.pwctax.com, or call your usual PricewaterhouseCoopers Services Pte Ltd contact.
SRI LANKA

SRI LANKA BUDGET 2004

Sri Lanka’s Finance Minister presented the Budget for the year 2004 on 19 November 2003. The main thrust of the Budget was four-fold: (1) continuing the fiscal consolidation with a view to reducing the budget deficit, (2) strengthening macro-economic stability and supporting the growth momentum, (3) employment generation and (4) providing relief to the public. In line with these objectives, several fiscal changes were announced, the more significant of which are discussed in the ensuing paragraphs.

PERSONAL INCOME TAXATION

Raising the Threshold and Widening Rate Band

Effective from the tax year 2004/2005, the tax threshold for resident individuals has been increased and the rate bands have been widened as follows:

<table>
<thead>
<tr>
<th>Taxable Income (Rs)</th>
<th>Tax Rate %</th>
<th>Cumulative Tax (Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 240,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Next 180,000</td>
<td>10</td>
<td>18,000</td>
</tr>
<tr>
<td>Next 180,000</td>
<td>20</td>
<td>54,000</td>
</tr>
<tr>
<td>Balance</td>
<td>30</td>
<td>-</td>
</tr>
</tbody>
</table>

Proposed

<table>
<thead>
<tr>
<th>Taxable Income (Rs)</th>
<th>Tax Rate %</th>
<th>Cumulative Tax (Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 300,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Next 240,000</td>
<td>10</td>
<td>24,000</td>
</tr>
<tr>
<td>Next 240,000</td>
<td>20</td>
<td>72,000</td>
</tr>
<tr>
<td>Balance</td>
<td>30</td>
<td>-</td>
</tr>
</tbody>
</table>

Higher Threshold for Terminal Benefits

The tax threshold for terminal benefits from employment has also been increased from the tax year 2004/2005 in the following manner:

Current

<table>
<thead>
<tr>
<th>Taxable Income (Rs)</th>
<th>Cumulative Tax (Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 1,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Next 500,000</td>
<td>5</td>
</tr>
<tr>
<td>Next 500,000</td>
<td>10</td>
</tr>
<tr>
<td>Balance</td>
<td>15</td>
</tr>
</tbody>
</table>

Proposed

<table>
<thead>
<tr>
<th>Taxable Income (Rs)</th>
<th>Cumulative Tax (Rs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 3,500,000</td>
<td>0</td>
</tr>
<tr>
<td>Next 500,000</td>
<td>5</td>
</tr>
<tr>
<td>Next 500,000</td>
<td>10</td>
</tr>
<tr>
<td>Balance</td>
<td>15</td>
</tr>
</tbody>
</table>

Revisions to Pay As You Earn (PAYE) Tax Scheme

A withholding tax of 10% to apply on
- the remuneration to a chairman or director of a company in addition to the payroll; and
- payment to non-executive directors.

Credit for the tax withheld could be set-off against the income tax payable for the relevant tax year by the recipient individual, but it is not refundable.
Valuation of Non-cash Benefits (on Private Use) Revised

Vehicles

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Car, jeep, van</td>
<td>Up to 1,500 cc</td>
<td>Rs 1,250 p.m.</td>
</tr>
<tr>
<td></td>
<td>Above 1,500 cc</td>
<td>Rs 2,000 p.m.</td>
</tr>
<tr>
<td>Motor cycle</td>
<td>Rs 250 p.m</td>
<td>Rs 2,000 p.m.</td>
</tr>
</tbody>
</table>

Residence (proposed)

When provided to directors and senior executives, i.e. employees drawing a monthly remuneration in excess of Rs 50,000

Rs 120,000 p.a

Payments Qualifying for Reliefs

Presently, certain qualifying payments are allowed to be deducted from an individual’s statutory income to arrive at his taxable income. The following changes will be made to the qualifying payments:

<table>
<thead>
<tr>
<th>Qualifying payments</th>
<th>Limitations</th>
<th>Carry forward period for any unabsorbed balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Donation to government, local government, provincial councils and universities.</td>
<td>Nil</td>
<td>Indefinite</td>
</tr>
<tr>
<td>• if in money</td>
<td>Limited to Rs 2m</td>
<td>Indefinite</td>
</tr>
<tr>
<td>• if in kind</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment (not less than Rs 500,000) in new shares of a venture capital company</td>
<td>50% of investment or 10% of statutory income, whichever is lower.</td>
<td>None</td>
</tr>
<tr>
<td>during its tax exemption period.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Housing:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On payments after 1 April 2002 (on first house after 1 April 2001).</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Loan repayment, and / or</td>
<td>Rs 100,000 or 10% of statutory income, whichever is lower.</td>
<td>None</td>
</tr>
<tr>
<td>• Own funds</td>
<td></td>
<td>9 years</td>
</tr>
<tr>
<td>Miscellaneous:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Donations to charities</td>
<td>Aggregate of Rs 75,000 or 10% of statutory income, whichever is lower.</td>
<td>None</td>
</tr>
<tr>
<td>• Contributions to approved Provident / Pension Funds not exceeding 12% of salary</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Life &amp; medical insurance premia</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
**CORPORATE INCOME TAXATION**

Several changes announced with respect to tax computations and taxation of business entities also have an impact on taxation of corporate income. The announced changes are discussed in the subsequent paragraphs under the headings “Taxation of business / professional entities” and “Computation of statutory income for income tax”. The few changes directly related to corporate income taxation are discussed under this heading.

**Payments Qualifying For Reliefs**

The rules with respect to qualifying payments which could be deducted from a company’s statutory income to arrive at its taxable income have been amended as follows:

<table>
<thead>
<tr>
<th>Qualifying payments</th>
<th>Limitations</th>
<th>Carry forward period for any unabsorbed balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Donation to government, local government, provincial councils and universities.</td>
<td>Nil</td>
<td>Indefinite</td>
</tr>
<tr>
<td>• if in money</td>
<td>Limited to Rs 2m</td>
<td></td>
</tr>
<tr>
<td>• if in kind</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment (not less than Rs 500,000) in new shares of a venture capital company during its tax exemption period.</td>
<td>50% of investment or 10% of statutory income, whichever is lower.</td>
<td>None</td>
</tr>
<tr>
<td>Donation to approved charities.</td>
<td>Rs 75,000 or 10% of statutory income, whichever is lower.</td>
<td>None</td>
</tr>
<tr>
<td>Investment Tax Allowance (any unabsorbed balance)</td>
<td>N/A</td>
<td>Cannot carry forward beyond the year of assessment ending on 31 March 2005.</td>
</tr>
</tbody>
</table>

**Profits on Sale of Taxable Shares**

Effective from 1 April 2004, the profits earned from the sale of shares, including rights, bonus shares, warrants and shares in a Board of Investment of Sri Lanka (BOI) company, will be subject to a tax of 15%.

It has been announced that this tax will apply to the profits on sale of shares held for a period of less than 2 years by any:

- corporate entity other than an overseas fund, and
- resident individual if his total net profits (on sale of such shares) exceed Rs 300,000 in a tax year.

**FCBU Offshore Profits-Taxable**

The profits derived from offshore transactions of the Foreign Currency Banking Unit (FCBU) of any banks, operating in Sri Lanka, which are presently tax exempt, will be chargeable to tax at 20% effective from 1 April 2004.

Consequently, FCBU profits will be subject to a dual rate:

- onshore profits at 32.5% (or 30% if listed, or 20% if taxable income is below Rs 5m); and
- offshore profits at 20%.
Withdrawal of Dividend Exemption
Any exemption currently applicable to dividends distributed would cease with effect from 1 April 2004 other than such dividends distributed by companies, which have prior to 6 November 2002,

- entered into an agreement with the BOI under Section 17 of the BOI Law; or
- qualified for specific exemptions as stipulated in Section 11(f) of the Inland Revenue Act No. 38 of 2000.

Royalty Payable by a BOI company
The royalty paid by a BOI company during its tax exemption period to a non-resident person is exempt from income tax. This exemption will henceforth not apply to royalty payments made by a BOI company which enters into an agreement with the BOI on or after 1 April 2004. Such royalty will be subject to a 15% withholding tax or a lower rate as provided for in an applicable double tax treaty.

New Tax Regime for Operators under the Petroleum Resources Act
The profits and income of any entity operating under a development licence issued by the Petroleum Resources Act, including a foreign subcontractor, would be chargeable to income tax at 15% with effect from the tax year 2004/2005.

Rental Income of a Company
Any rental income earned by a company on premises let for commercial or other purposes will be treated as business income.

Forestry
The definition of “business” in the tax statute will be amended to include forestry.

Non-recurring Income Liable to Tax
Winnings from lotteries, betting and gaming will be deemed to be taxable sources of income.

TAXATION OF BUSINESS / PROFESSIONAL ENTITIES

Economic Service Charge
An Economic Service Charge (ESC) at 1% of turnover or total assets will be imposed on all entities carrying on any trade, business, profession or vocation if they (a) have a turnover in excess of Rs 30 million, or total assets in excess of Rs 10 million, whichever is lower; and (b) have been in commercial operations for more than 2 years.

ESC can be set off against the income tax payable by the business / professional entity for the relevant year, limited to the full amount of tax payable without any carry over provision. The minimum and the maximum amount of ESC that an entity will be liable for any year of assessment will be Rs 100,000 and Rs 20 million respectively.

ESC will be charged on legislation to be enacted, separate from the income tax law. It is aimed at ensuring that every business / professional entity, even if incurring losses, would make a financial contribution to the government for its use of the country's infrastructure. ESC is in line with the minimum tax concept followed by countries such as the United States and India.

Taxation of Partnership Income
An upfront tax of 10% will be imposed on the divisible profits and other income of a partnership. This upfront 10% tax can be set off against the proportionate individual tax liability of each partner, up to a maximum of his tax payable without carry over provision.

Sri Lanka presently adopts the personal approach wherein the income of the partnership is apportioned to each partner and added to the income from other sources to determine his tax liability. However, the present form has an inherent vulnerability to tax avoidance through income splitting. The proposed entity approach has a distinct advantage in terms of administrative efficiency and would also help prevent income splitting and generate higher revenue. However, in order to satisfy the equity objective and to cause minimal hardships to small partnerships, the present proposal combines the entity approach with the personal approach.
COMPUTATION OF STATUTORY INCOME FOR INCOME TAX

Few changes were announced to the rules for determining statutory income for income tax purposes, which will take effect from 1 April 2004.

Depreciation Rates Revised

The annual permissible tax depreciation rates effective from 1 April 2004 will be as follows:

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Present</th>
<th>Proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT equipment and accessories including software</td>
<td>100%</td>
<td>25%</td>
</tr>
<tr>
<td>Vehicles and furniture</td>
<td>25%</td>
<td>20%</td>
</tr>
<tr>
<td>Plant and machinery</td>
<td>50%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Intangible assets (other than goodwill)</td>
<td>-</td>
<td>10%</td>
</tr>
<tr>
<td>Bridges, railways, reservoirs, electricity or water distribution lines and toll roads</td>
<td>50%</td>
<td>6 2/3%</td>
</tr>
<tr>
<td>Buildings(^1)</td>
<td>6 2/3%</td>
<td>6 2/3%</td>
</tr>
</tbody>
</table>

Roll Over Provision

Roll over relief is to be provided where a depreciable asset is replaced either 6 months prior to or 6 months after the disposal of such asset. Presently, the profit on disposal of a depreciable asset is excluded from the chargeability to tax if the full sale proceeds are utilised in replacing such asset within one year of the date of sale.

Taxable Profit on Disposal of Fixed Assets

On disposal of depreciable assets, the taxable profit or loss on disposal would be computed by reference to the total sale proceeds. Currently the excess over the original cost is currently deemed to be a capital gain and not taxable.

Leased Assets Transferred to Lessee

To the Lessor: When the leased asset is transferred to the lessee, the value on transfer will be deemed to be the market value as at the date of transfer. The excess, if any, of the market value of the asset at the date of transfer over the amount of lease rental plus ultimate sales proceeds received by the lessor would be treated as taxable.

To the Lessee: Where a leased asset is acquired by the lessee and the lease rental has been claimed as deductible in part or in full, the entire amount of sale proceeds on its subsequent disposal would be treated as business income.

Employee Costs

Amendments will be made to available expense deductions in respect of the following employee benefits:

- cost of providing a residence and assets at the residence,
- domestic and private expenses of partners and employees,
- movable and immovable property granted to employees at a value less than the market value,
- loans, advances, credits to employees which are later written off, and
- cost of providing more than one vehicle to an employee or non-employee.

Additional superannuation scheme contributions by employer, if they are certified by an actuary, will be allowed as a deduction.

Removal of Limitation on Management Fee

The present limitation on the maximum amount of management fees deduction will be removed. The deductibility is now limited to Rs 1 million or 1% of turnover, whichever is lower, unless a higher amount is determined as justifiable by the Commissioner General of Inland Revenue.

\(^1\)Includes any industrial or hotel building that has been purchased from any person who has used that building in any trade or business.
Exclusion of Assessable Income Computation

In the computation of income tax, the concept of assessable income will be excluded and only the concepts of statutory income and taxable income will be used.

TAX TREATMENT OF LOSSES

New rules on the tax treatment of losses will apply from 1 April 2004.

- Any business could set off losses, both current year and brought forward, against income earned in any tax year only to the extent of 35% of that year’s statutory income. Any balance could be carried forward, but subject to the same 35% limitation.

- The following current limitations on carry forward of losses will be removed:
  - losses attributable to capital allowances
  - agricultural losses
  - other trade losses

- Existing provisions regarding carry back of losses, on cessation of business, will be removed.

- Limitation on setting off losses from horse racing, leasing and FCBU onshore transactions to the income from the same category is also proposed to be removed.

- Carry back provisions with respect to capital losses set off against statutory income of the three preceding years (in case of a liquidation) will be withdrawn.

- Losses generated by way of intra-group transactions, which are deemed to have no economic substance, will be disallowed. Losses arising from transfer pricing appear to be targeted.

WITHHOLDING TAX

On Interest Deposits

The exemption limit will be increased to Rs 25,000 per month or Rs 300,000 per annum and be applicable to the aggregate sum from all deposits in case of individuals whose sole or main source of income consists of such interest. The concerned individuals will be required to submit a declaration to that effect to the respective bank or financial institution.

On Annuities, Royalties and Management Fee

Commencing from 1 April 2004, withholding tax will apply to:

<table>
<thead>
<tr>
<th>Description</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annuity or Royalty in excess of Rs 50,000 p.m. or Rs 500,000 p.a.</td>
<td>10%</td>
</tr>
<tr>
<td>Management Fee or similar payment</td>
<td>5%</td>
</tr>
</tbody>
</table>

The payment of an annuity or royalty to a person outside Sri Lanka is presently subject to a 20% withholding tax, or the lower double tax treaty rate, if applicable. The proposed rate will not apply to overseas payments. Currently, there is also a withholding tax of 5% on payments made in consideration for services rendered. It would appear that management fees would be brought under a regime distinct from services in general.

VALUE ADDED TAX (VAT)

Single VAT Rate

A single VAT rate of 15% has replaced the former standard rate of 20% and the lower rate of 10%, pursuant to a budget proposal, from 1 January 2004. The zero rate continues. The unified single rate is an administrative facilitation measure and is also aimed at eliminating market distortions which the dual rate system generated. It also recognises the fact that, as a result of the lower rate, the standard rate has to be placed at a level higher than it would otherwise be to maintain revenue neutrality. With a view to mitigating any upward pressure on the cost of living, some socially important goods and services are included in the VAT Exemption Schedule.

Raising VAT Threshold

The turnover threshold will be increased, also from 1 January 2004, to Rs 750,000 per quarter or Rs 3 million per annum from the current levels of Rs 500,000 per quarter or Rs 1.8 million per annum.
VAT on Wholesale and Retail Trade

The levy of VAT on the wholesale and retail trade, which was announced in the Budget 2003, has been deferred. However, where goods are acquired from an associated person (the term “associated person” is defined in the VAT Law), chargeability to VAT on the wholesale or retail supply of goods will apply. This change has been implemented from 1 January 2004.

VAT Refunds at Airport

Foreign visitors would be entitled to a refund of VAT paid on specific goods purchased from VAT registered retailers (subject to a minimum value) at the time of their departure at the airport, provided the goods are removed from Sri Lanka within two months from their dates of purchases. It is proposed to implement this refund scheme in early 2004.

Changes to VAT Refund Process

Refund of excess input tax will be made only after six months from the end of the relevant taxable period (month or quarter) in which the refund arose other than in respect of

- BOI companies (during the project implementation period),
- new businesses registered under Section 22(7) of the VAT Law, and
- zero rated supplies (51% or more zero rated supplies in case of mixed supplies),

which would continue to receive their refunds within a month from the end of the taxable period or the date of filing the return, whichever is later.

TAX COMPLIANCE

Changes to Tax Payment Process

Presently, a taxpayer is required to make a self assessment of his annual tax liability and make payment in four quarterly installments. So long as the quarterly installments are at least equal to one fourth of the preceding year tax liability, any balance could be paid by 30 September of the subsequent tax year without incurring late payment penalties.

It is proposed to allow payment of the 1st and 2nd installments to be estimated on the basis of the tax payable for

- the previous tax year, or
- the immediate year preceding the previous tax year.

The 3rd and 4th quarter installments would need to be paid on the existing basis.

Registration with the Inland Revenue

All companies and partnerships and any other business registered with the following bodies are required to open a file with the Department of Inland Revenue, to file an annual return of income together with relevant financial statements for each tax year, whether or not liable to income tax.

- Registered with the Registrar of Companies, or
- Registered with the Registrar of Business Names

Similarly, all persons liable to deduct and remit any Withholding Tax are also required to register with the Department of Inland Revenue and file monthly returns along with the payment.

New Penalty Regime

Effective from 1 April 2004 a new penalty regime will be introduced, the key feature of which is the segregation of the respective penalty and interest components. The penalty and interest will be structured as follows:

<table>
<thead>
<tr>
<th>Penalty on Late Payment / Non-Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability accepted but not paid</td>
</tr>
<tr>
<td>5% of the tax on due date and additional 1% per month thereafter, subject to a cap of 10%</td>
</tr>
<tr>
<td>Assessment on non-filing of return</td>
</tr>
<tr>
<td>10% of tax on due date</td>
</tr>
<tr>
<td>Tax under appeal and payable on settlement of appeal</td>
</tr>
<tr>
<td>10% of tax payable on settlement</td>
</tr>
</tbody>
</table>
RATIONALISATION OF TAX INCENTIVE FRAMEWORK

Concessions are accorded in terms of the Inland Revenue Act (tax statute) (the Act) and under the BOI Law. It is proposed to rationalise the incentives under the Inland Revenue Act to bring them in line with those granted under the BOI Law.

Section 21A of the Act - 5 years tax holiday for specified activities
- Animal husbandry, deep sea fishing, manufacture of machinery and export or deemed export of services to be included as “specified services”.
- The minimum investment to qualify under this section to be increased to Rs 10 million for a new company and Rs 50 million for an existing company.
- Application of Section 21A for investments in excess of Rs 250 million to be limited to pioneering projects.
- Where the investment is in excess of Rs 1 billion, relief to be aligned with that available under Section 21B of the Act (i.e. large scale infrastructure projects qualifying for 6-12 years tax holiday).

Section 21C of the Act - 5 years tax holiday for small scale infrastructure projects
- The upper limit of Rs 50 million to be removed.
- Redevelopment of housing schemes to be included for relief.

Section 21D of the Act - 5 years tax holiday for research and development activities
- Exemption to any undertaking involved in Research and Development to be limited to income earned from that activity only.

Sections 21F and 21G of the Act - 2 year tax holiday for export / deemed export profits on expansion of undertakings for non-traditional products, and on incremental profits from expansion of undertakings for manufacture of traditional products and non-exportable goods.
- The investment for expansion of existing business will be extended to 31 December 2004.

The following additional tax concessions only available under the BOI Law will be included in the Inland Revenue Act:
- the acquisition of assets of existing undertakings involved in large scale infrastructure projects,
- Regional Operating Headquarters for specified activities, and
- Export trading houses within a Free Trade Zone.
Withdrawal of Tax Exemptions

It is also proposed to withdraw some of the existing tax exemptions, with effect from 1 April 2004.

- Exemption on entrepot trading (stones, metal, petroleum, gas and other approved items) and provision of warehousing facilities for entrepot trading.

- Fees received by employment agencies from Sri Lanka Bureau of Foreign Employment.

- With the exception of international and multilateral organisations, the exemption of other income (excluding grants and donations) of certain institutions listed in Section 8(a) of the Inland Revenue Act.

(A tax at 10% will apply to the above categories).

- 75% exemption of profits from construction and sale of houses. (This activity is now covered under Section 21C of the Act).

CUSTOMS AND EXCISE

Tariff Structure Rationalised

As part of the continuing process of rationalising the tariff structure, the duty rate bands were reduced from 1 January 2004 to five - 3%, 6%, 12%, 20% and 27.5%. The specific duties on certain agricultural commodities and also the preferential rates under the Indo-Sri Lanka Free Trade Agreement, South Asian Preferential Trade Agreement (SAPTA), Global System of Trades Preferences (GSTP) and the Bangkok Agreement will continue. The surcharge on Customs Duty was reduced from 20% to 10% from 1 January 2004.

Changes in Excise Duty

Excise Duty on beer was increased with immediate effect by

- Rs 5 per litre on beer with alcohol strength of less than 5%, and
- Rs 10 per litre on beer with alcohol strength of 5% or more.

Excise Duty on rectified spirit issued for industrial purposes was increased from the current rate of Rs 36 to Rs 200.

The Government also introduced other changes to the excise duty structure in order to maintain revenue neutrality, with the introduction of a single VAT rate from 1 January 2004.
REAL PROPERTY SECURITISATION

In July 2003 the Real Property Securitisation Law (RPSL) was officially promulgated with a view to revitalise the real estate market, heighten the liquidity of real estate, and bring greater diversity to the securities market. The RPSL provides two possible methods to securitise real properties, namely “real estate investment trust” (REIT), and “real property holding trust” (RPHT).

Under the REIT, a trust may be established with funds raised by the distribution and delivery of the beneficial securities, whether through public offering to non-specified persons, private placement to specified person, or else, and with the purpose of investing the funds in real property, real property related rights, real property related securities and other subjects approved by the competent authority.

On the other hand, under the RPHT framework, the settlor of a trust may entrust its real property or real property related rights to a trustee, which raises the funds by the distributing and delivering of the beneficial securities, whether through public offering to non-specified persons, private placement to specified person, or else, to affirm the beneficiaries’ profits, interests, income and other rights in connection with the real property and real property related rights so entrusted.

Under the RPSL, only real property or real property related rights that generate existing steady income may be securitised. In other words, both REIT and RPHT cannot raise funds from investors of the beneficial securities for the purposes of developing and/or investing in real properties that cannot generate steady income.

Also the settlor shall cancel or annul any mortgage or lien on the trust property, and submit the relevant documentary proof to the trustee. In the event that such mortgage or lien cannot be cancelled or annulled, the settlor of a trust shall submit to the trustee the consent, notarised by the court, that the mortgagee or holder of the security interest shall not exercise the mortgage or security interests during the term of the trust agreement. In addition to taxation rules provided under the Income Tax Law, the RPSL also offers the following tax incentives in order to facilitate securitisation in Taiwan:

- At the time of entrusting land, no land value incremental tax shall be applicable if the land is required to be returned to the settlor of a trust upon the termination of the trust;
- Sale or purchase of the beneficial securities issued or delivered in accordance with the RPSL shall be exempted from securities transaction tax. In addition, capital gains realised from trading of the said securities are also currently exempt from tax assessment;
- Trust income distributed to the beneficiary shall be subject to a final withholding tax at the rate of 6%;
- The trustee of a REIT or RPHT that holds land as trust property and distributes, publicly offers or privately places the beneficial securities shall be the taxpayer during the term of the trust in respect of the applicable land value tax. The taxable amount shall be calculated in accordance with the aggregate land value of all the entrusted land located in the same city or county under the same trust plan, applying the applicable land value increment tax rate under the Land Tax Law;
- Building may be depreciated for a term that is one half longer than what is set forth in the fixed asset depreciation chart (e.g. 50 years for concrete structure building).
Taiwan

TRANSFER PRICING

The Ministry of Finance (MOF) in Taiwan has included Transfer Pricing (TP) rules in the revised “Assessment Rules for Income Tax Returns of Profit-Seeking Enterprises” (Assessment Rules). The revised Assessment Rules became effective from 2 January 2004. The purpose of the TP rules is to protect the taxing rights and tax base in Taiwan by adjusting the transfer prices of related parties transactions which resulted in the group companies retaining operating profits in low-tax or tax-heaven countries.

The revised Assessment Rules empower the tax authorities to adjust the transfer prices of the group companies in the following order (i.e. only if the first method is not applicable, the tax authorities may use the second method, and so on) if the tax authorities discover that the group companies manipulate their profits by non-arm's length transaction prices:

- Comparable Uncontrolled Price;
- Resale Price Method;
- Cost Plus Method; and
- Other method approved by the MOF.

In addition, the revised Assessment Rules also introduce the Advanced Pricing Agreement (APA) mechanism for group companies that conduct related parties transactions to obtain prior approval from the tax authorities for the relevant transfer prices and acceptable pricing methods before the end of the financial year in which the related parties transactions are conducted.

As the application procedure is complicated and the cost involved is high, it is likely that the tax authorities will further stipulate the application procedure and the threshold for eligible APA applications.

The revised Assessment Rules also specify that if the taxpayer's related parties transactions are subject to TP adjustments by the Taiwan tax authorities and the counter-party that involves in the said transactions is also a Taiwan tax resident, the tax authorities may adjust the taxable income of the counter-party accordingly. If the counter-party is a non-tax resident in Taiwan, the taxable income of the counter-party may only be adjusted via the mutual agreement procedure of the relevant tax treaties.

CHANGE OF POLICY ON TAXATION OF STOCK ACQUISITIONS

Effective from 1 January 2004, capital contributions with intangible properties (e.g. technical know-how, patents, trademarks, and goodwill) in exchange for shares of a Taiwanese company will give rise to taxable gain based on the difference of the total fair market value of the shares and the cost of acquiring or developing the intangible properties, pursuant to the tax ruling (#09204553212) released by the MOF on 1 October 2003.

This tax ruling repeals the tax treatments set forth by tax rulings of 1985 and 1986 (rulings #35333, 7564235). In the past, such exchanges were treated as tax-free exchange of one property for another with no gain realised on the exchange. As a result, there were no tax consequences arising from the transaction until the subsequent disposition of the stocks.

Nevertheless, the new Ruling, superceding all existing MOF rulings on this subject matter, became effective on 1 January 2004 and will:

(a) treat the portion of the subscription price in excess of the cost of developing or acquiring intangible asset(s) (Premium) as income of the subscriber derived from property transactions within the meaning of Income Tax Law and thereby, taxable upon the receipt of the technical shares; and

(b) repeal MOF rulings 35333 and especially 7564235 that provide a shareholder to be liable to pay income tax on the Premium upon sale, transfer or other disposition of Technical Shares.

By virtue thereof, the MOF in essence eliminates the shareholders’ tax liability on the Premium of Technical Shares upon disposition but only to interpose the same at the time of subscription.
ADVANCED RULING APPLICATION

The Taiwan government introduces a so-called “Advanced Ruling Application” mechanism from year 2004. According to the Guidelines for the Advanced Ruling Application (Guidelines), which was taken into force on 1 January 2004, any foreign enterprise intending to invest in Taiwan or carry out cross-border transaction with local enterprises within one year may consider the application of an advanced ruling with the MOF for clarification of the relevant tax issues, on condition that the investment or transaction met one of the following criteria:

- The investment amount is expected to be no less than NT$200,000,000 (approximately US$5,882,352), or the first transaction amount is expected to be no less than NT$50,000,000 (approximately US$1,470,588).

- The investment or transaction will significantly benefit the economy in Taiwan.

The Guidelines also state that the MOF will not accept the advanced ruling application under any one of the following circumstances:

- The application involves the confirmation of simple facts or valuation of assets.

- The transaction is presumptive or would not be actually conducted within one year.

- The transaction has occurred or the tax return that contains the said transaction is about to file or has filed.

- The main issues of the application are similar to the cases that are in the process of administrative appeal.

- The information provided by the applicant is insufficient and the applicant does not provide supplementary information within the timeframe specified by the MOF.

- The statement in the application is incorrect or false.

- The application involves transfer pricing issues, i.e. the determination of the revenue, cost and expenses of the inter-company transactions prescribed by Article 43-1 of the Income Tax Law.

- The application involves interpretation of laws and regulations that are not relevant to taxation.

- The application involves interpretation of laws and regulations of foreign countries.

- The purpose of the application is for tax avoidance and the taxpayer does not consider in bona fide to conduct the transaction.

- Other cases that are not appropriate for the advanced ruling application.
Normal Specific Business Tax Rate Reverted

One of the industries hit hardest by the country’s sluggish economy was the real estate sector. In order to boost this sector, the government extended the reduced Specific Business Tax (SBT) rate of 0.11% (from 3.3%) to 31 December 2003. As a result, the sector began to show an improvement and the government, therefore, decided not to extend the reduced SBT rate further. Thus, the normal SBT rate of 3.3% resumed on 1 January 2004.

Extension Period for Tax Privileges for Debt Restructuring

The exemptions from personal income tax, corporate income tax, stamp duty, SBT and value-added tax (VAT) in a debt restructuring process under Bank of Thailand (BOT) guidelines are extended from 31 December 2003 to 31 December 2004.

This Royal Decree, which was effective on 1 January 2004, merely extended the privileges of Royal Decree No. 410 which expired on 31 December 2003.

The Revenue Department issued the Notification of the Director General dated 2 February 2004 to provide instructions and methods for transferring debtors’ immovable property, which had been pledged with the creditor’s financial institutions, to repay the debt. This Notification also provides a standard declaration form which obligates the debtor to return the sales proceeds as debt repayment.

Continuation of 7% VAT Rate for 2 More Years

On 20 September 2003, Royal Decree No. 416 was enacted to extend the period of imposition of the current VAT rate for 2 more years. Therefore, with effect from 1 October 2003 to 30 September 2005, the VAT rate of 7% will continue to be imposed on the sale of goods, provision of services and import of goods.

Identification Number instead of Tax Identification Number

Effective on 1 October 2003, an individual who has and uses a citizen identification (ID) number according to the Law Governing Population Registration is entitled to use his / her citizen ID number in lieu of a tax ID number for filing a personal income tax return and withholding tax return. A tax ID number and a tax ID card are no longer needed. This applies to current tax ID users.

This measure is to encourage the use of citizen ID numbers as the principal, national ID numbers.

However, in the case of a personal income taxpayer who does not have a citizen ID number according to the Law Governing Population Registration, i.e. a foreigner, ordinary partnership, body of person who is not a juristic person, undivided estate, etc.; an individual who needs to apply for VAT or SBT registration; and a VAT or SBT registrant who registers before this Notification was effective, they are still required to have and use tax ID numbers.

Withholding Tax and VAT of Freight Forwarders, Logistic & Shipping Companies

Revenue Department Instruction No. Paw 124/2546 provides guidelines on the treatment of withholding tax and VAT on payments to freight forwarders, logistic and shipping companies who act on behalf of importers and exporters (the owners of the goods) in carrying out the process of customs clearance.

The Instruction covers treatment of the following fees:

(1) Taxes and fees paid to the Customs Department for customs clearance on behalf of the owner of the goods.

(2) Fees and expenses which are relevant to the importing and exporting of goods such as gate charge, lift on / lift off charge, re-location charge supported with receipts issued in the name of the importers or exporters.

(3) Service fees of the shipping agents.

(4) Gratuity or other undocumented expenses which are incurred for or on behalf of the owner of the goods and the owner accepts them as having been incurred.
The treatment is as follows:

- The expense under item (1) is not subject to either withholding tax or VAT irrespective of who the payer is.

- The fees under items (2) and (3) are treated as income under Section 40(2) and subject to VAT and withholding tax at 3% where the recipients are juristic companies or partnerships under Section 39 of the Revenue Code.

- If the shipping agents pay the fee under item (2) on behalf of the goods owner to any persons who are subject to tax under Section 39, they must withhold the taxes on behalf of the owner of the goods.

- The expense item (4) which is included in a collection invoice of the shipping agent is treated as item (3) and is subject to VAT and withholding tax in the same manner.

- The owners of the goods reimbursing or advancing the shipping agents for any amounts under items (1) and (2) are not required to withhold tax or subject to VAT on the reimbursement or advancement.

- The Instruction indicates that the owner of the goods is allowed to treat the fees under items (3) and (4) charged by the shipping agents as tax deductible expenses, while being treated as taxable income of the shipping agents.

**Withholding Tax & VAT on Telephone Service Charge**

The Revenue Department has clarified in its Instruction No. Paw 125/2546 the withholding tax and VAT treatments on various types of charges in relation to telephone services. The Revenue Department also clarified which person is liable to withholding tax and which person is eligible for VAT recovery in the situation where the applicant for use of a telephone number and the person who uses the telephone and pays the fees are different persons. This Instruction was effective on 3 February 2003.

Following are fee charges referred to in the Instruction:

1) Telephone number application fee
2) Registration fee
3) Telephone number service fee
4) Deposits for telephone number
5) Other service fees similar in nature to the abovementioned fees
6) Telephone call rates or other service fees of a similar nature

The fees under items (1) to (5) are subject to withholding tax at the rate of 5% while the fees under item (6) are at the rate of 3%. However, for VAT purposes, all of the fees are considered as service fee and subject to VAT.

However, if the deposit amount under item (4) is not more than six times the telephone number monthly fee and refundable upon the end of contract, the deposit is not considered to be taxable income of the service provider and therefore not subject to withholding tax. Nevertheless, it is still regarded as service fee for VAT regime.

**Withholding Tax on Air Freight Charges for Transportation of Goods**

The Revenue Department Instruction No. Paw 126/2546 issued on 25 March 2003 provides a guideline for air freighters and forwarders on withholding tax obligation and withholding tax certificate issuance.

Outbound shipment – Air freight charge is subject to 1% withholding tax. The withholding tax may be exempt depending on the double tax treaty between Thailand and the resident country of the foreign air freighter.
Inbound shipment – As the inbound service is not subject to corporate income tax under Section 67, the service provided by foreign freighters and agents of foreign forwarders is not subject to withholding tax. However, inbound freight services provided by Thai air freighters are subject to 1% withholding tax.

Although not included in an airway or house airway bill, any fees or benefits relevant to the outbound or inbound international freight are treated as freight charges and subject to withholding tax at 1% as mentioned above, however handling charges are treated as service fees which are subject to 3% withholding tax.

This Instruction also applies to a formally appointed agent of the air freighters in the same manner as it does to the air freighters.

Director-General Notification No. 127
Tax Return Filing via the Internet
Effective on 1 May 2003, PND 50 (annual corporate tax return forms), PND 52 (annual corporate tax return forms for foreign companies carrying on international transport) and PND 55 (annual corporate tax return forms for foundations and associations engaged in any revenue-producing business) can be filed via the Revenue Department website (http://www.rd.go.th.) with a prior approval from the Revenue Department.

The deadline for filing is the same as that for traditional methods of filing annual tax returns, i.e. within 150 days of the close of an accounting period. Returns may be filed on the website daily until 10 p.m..

Unlike filing in a paper form, those filing their PNDs via the internet are not required to submit a set of financial statements, statement of receipts and expenditure or a statement of gross receipts which were audited and certified by a certified public accountant or a tax-accounting auditor. However, such documents and other accounting reports must be maintained at the head office of the company or partnership for at least 5 years from the last day of the time limit for filing a tax return for that accounting period.

Customs Department Notification on the General Agreement on Tariffs and Trade Valuation
On 25 September 2003, the Customs Department released 7 Notifications on the General Agreement on Tariffs and Trade (GATT) Valuation to provide clear technical and practical guidelines on GATT Valuation. This move was prompted by difficulties faced by importers due to variations in interpretations by different parties.

These new regulations were effective from 1 October 2003. Details are as follows:

- No. 56/2546 on request for explanation of and justification for fixing customs valuation.
- No. 57/2546 on procedural practice with respect to discussion between the Customs Department and importers.
- No. 58/2546 on submission of documentation in support of import entry.
- No. 59/2546 on verification of the relationship between seller and purchaser.
- No. 60/2546 on royalties and licence fees.
- No. 61/2546 on description of values of insurance premiums, freight charges, goods discharge fees, loading fees and other management fees.
- No. 62/2546 on description of computed values.
VIETNAM

CHANGES TO TAX LAWS

Amendments to the Value-added Tax (VAT), Business Income Tax (BIT) and Special Sales Tax (SST) Laws were passed by the National Assembly in June 2003 and became effective from 1 January 2004. The key amendments to each of these laws are highlighted below.

VAT Law

Non-taxable goods and services

There are 29 categories of non-taxable goods / services as compared to 26 in the past. The additional categories include:

- Guarantee of loans, discount of commercial bills and valuable papers, sale of loan assurance assets for the purpose of debt recovery; and
- Overseas reinsurance services (previously 10%).

Taxable goods and services

The list of taxable goods and services has been expanded to include SST goods and services at production or importation stage. Exported services are now subject to 0% VAT.

VAT rate changes

There are 3 VAT rates: 0%, 5% and 10%. The 20% VAT rate has been removed.

<table>
<thead>
<tr>
<th>0%</th>
<th>Now also applies to exported services.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>Now also applies to certain goods such as sugar and its by-products and industrial concrete products that were previously taxable at 10%.</td>
</tr>
<tr>
<td>10%</td>
<td>Applies to construction and installation activities (previously taxable at 5% VAT) and all goods / services previously subject to 20%.</td>
</tr>
<tr>
<td></td>
<td>Certain goods and services provided to Export Processing Enterprises (EPEs) and Export Processing Zones (EPZs) are now taxable at 10%, including insurance, banking services, telecommunication, consulting, accounting, auditing, transportation, goods loading, office rent, goods / services supplied for personal use, and petrol for means of transportation.</td>
</tr>
</tbody>
</table>

VAT input deduction

Deemed VAT input credit for those entities using the tax deduction method is no longer applicable.

VAT annual finalisation

Two new prescribed tax forms are required to be completed.

Transitional rules

Construction and installation contracts signed before 1 January 2004 will continue to be subject to 5% VAT for works that were in progress as at 31 December 2003. SST goods manufacturers are entitled to claim input VAT credits for raw materials purchased before 1 January 2004.

BIT Law

Taxable income

- Organisations will be subject to BIT and individuals will be subject to Personal Income Tax (PIT) on income from the transfer of land use rights.
- Lease prepayments received may either be taxed upfront on the total payment received less accrued expenses or amortised on an annual basis for BIT purposes.

Deductible expenses

- **Depreciation**: the depreciation rates for BIT purposes must be in accordance with the provisions of Decision 206 (Decision 166 has been repealed).
- **Salaries and wages**: for foreign investment enterprises (FIEs) and local private enterprises, the labour contracts or collective labour agreements will form the legal basis for calculation of the salaries and wages expenses. Total expected salary and wage funds are required to be registered with the tax authorities.
Vietnam

- **Interest expense on capital borrowings**: the amount of deductible interest will be the actual interest expense but limited to 1.2 times the bank lending rate (previously not higher than the highest bank interest rate at the time of transaction).

- **Head office cost allocations**: permanent establishments in Vietnam which do not comply with Vietnamese Accounting System (VAS) shall not be entitled to claim head office cost allocations.

- **Advertising and promotion**: now capped at 10% of the total deductible expenses (as compared to 5% - 7% in the past).

**BIT finalisation**
Deadline for BIT annual return submission is 90 days after fiscal year end. This applies to both FIEs and local enterprises (previously 60 days for local enterprises). There is a new format for BIT return.

**Losses carried forward**
Enterprises must register their plan for using loss carried forward with the tax authorities. Enterprises will not be allowed to deduct losses of previous years if they fail to register. Once registered, losses may be carried forward for five years.

**SST Law**

**Services subject to SST**
The list of services has been expanded to include:

- Lottery activities; and
- All kinds of legal gambling for amusement (previously only horse racing and vehicle).

**Taxable price**

- As a general rule, the taxable price of SST goods and services is the average retail selling price of the goods / service excluding SST and VAT.

- For alcohol and beer manufactured domestically only, the cost of the bottles or cans purchased or produced will be excluded from the taxable price for SST purposes (previously only alcohol products were entitled to this treatment).

- Where goods are sold through distributors, the taxable price will be equivalent to the average selling price to the distributor. However, if the average retail market price is 10% greater than the average selling price to the distributor, the tax authorities may deem the SST payable based on the average market price.

**Tax rate**
There are changes in tax rates on automobile, beer, alcohol, air-conditioners, etc.

**SST exemption and reduction**
The 5-year SST reduction for beer manufactures established before 1 January 1999 and 3-year SST reduction for golf courses have been removed. Automobile manufacturers shall be entitled to SST reductions from 2004 to 2006.
Tax declaration and payment deadlines

- Deadline for tax payment: 25th of the following month (previously no later than 20th of the following month).
- Deadline for SST annual finalisation: 45 days after calendar year end (previously 60 days).

Depreciation of Fixed Assets

New regulations on depreciation of fixed assets were passed on 12 December 2003 and became effective from fiscal year 2004. A summary of the key changes introduced is as follows:

- **Tangible fixed assets:** must satisfy all the following criteria:
  - Economic benefits should arise from use of the fixed assets.
  - Cost of the fixed assets should be reliably determined.
  - The useful life of the fixed assets should be one year or more.
  - The original cost of the fixed asset should be VND10,000,000 or above (previously VND5,000,000).

- **Intangible fixed assets:** intangible fixed assets must also satisfy the above 4 criteria (as for recognition of tangible fixed assets). Any expenditure which does not meet all of the 4 above-mentioned conditions for tangible assets shall be accounted for as a prepayment and amortised over a number of years, i.e. such expenses will be accounted for as business expenses and not fixed assets. During the development period, an intangible asset shall be recognised if it satisfies 7 criteria as listed in Decision 206. For intangible assets, some additional detailed regulations on determination of the original cost of fixed assets are provided, including exchanges, computer software, grant / donation / gift, and internal created fixed assets.

- **Depreciation of fixed assets:** land use right is a special intangible asset that is not subject to depreciation.

- **Useful life of tangible fixed assets:** it is determined based on the prescribed useful life for each fixed asset as stipulated in Decision 206.

Personal Income Tax (PIT) Ordinance

An amended PIT Ordinance has been passed by the National Assembly and will become effective as of 1 July 2004. Key changes are as follows:

1. For Vietnamese employees, the taxable threshold has been increased from VND3 million to VND5 million.
2. The tax brackets have been widened for Vietnamese employees (see table below).
3. The 50% rate has been removed for both Vietnamese and foreign employees.
4. The 30% surtax for Vietnamese employees has been abolished.
The new PIT rates are as follows:

<table>
<thead>
<tr>
<th>Average monthly income for Vietnamese employees (VND Million)</th>
<th>Average monthly income for foreign employees (VND Million)</th>
<th>PIT rates (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 5</td>
<td>Up to 8</td>
<td>0</td>
</tr>
<tr>
<td>From 5 to 15</td>
<td>From 8 to 20</td>
<td>10</td>
</tr>
<tr>
<td>From 15 to 25</td>
<td>From 20 to 50</td>
<td>20</td>
</tr>
<tr>
<td>From 25 to 40</td>
<td>From 50 to 80</td>
<td>30</td>
</tr>
<tr>
<td>Over 40</td>
<td>Over 80</td>
<td>40</td>
</tr>
</tbody>
</table>

Another important change in the new ordinance is the treatment of expatriates spending less than 30 days in Vietnam per year. Previously such expatriates were exempt from PIT. Now they will be subject to 25% PIT on their Vietnam sourced income (i.e. in the same way as non-residents spending between 30 and 183 days in Vietnam per year).

**Proposed Foreign Contractor Withholding Tax (FCWT) changes**

Following the introduction of the new VAT and BIT laws effective from 1 January 2004, new rules on FCWT are being drafted. These will replace the existing FCWT regulations.

The draft regulations include some very significant changes, notably an increase in scope to include services whether performed in or outside of Vietnam, and substantial increases in some of the tax rates.

While some transitional “grand-fathering” provisions will apply, the rules are likely to come into effect on 1 July 2004. In some cases, use of Double Taxation Agreement partner jurisdictions might help mitigate some of the effects.

Foreign contractors and their customers need to be aware of these potential changes, and assess how they may be affected. The scope of application of the FCWT is very wide, and covers many payments made by Vietnamese companies (foreign and locally invested) to foreign companies which do not have a licensed presence (e.g. a subsidiary) in Vietnam. As such, the FCWT changes may impact both the Vietnamese customer, and their foreign suppliers depending on whether the contractual price is net or gross of tax.

**Labour Laws**

New requirements in relation to the employment of foreign nationals became effective on 7 October 2003. The new regulations are quite onerous and, if not complied with, may ultimately result in the deportation of foreign employees.

The new regulations stipulate that Vietnamese enterprises, including enterprises established under the Law on State Owned Enterprises, the Law on Enterprises and the Law on Foreign Investment, may only employ foreign nationals at a maximum rate of 3% of their total workforce but in any case are not allowed to employ more than 50 foreign nationals. Other organisations are not subject to the above limitation, but are required to obtain prior approval from the provincial People’s Committee if they want to employ foreign nationals.

Vietnamese enterprises must now publicly announce any foreign employee requirements in three consecutive issues of a central or local newspaper. However, it is unclear whether this requirement would apply to internal transfers and secondments or to what extent it will be enforced in practice.

Foreign nationals working in Vietnam are required to obtain a work permit. However, the following categories of employees are not required to obtain a work permit:

- Employees who work for less than three months;
- Employees who are sent to Vietnam to attend to an emergency;
- Members of the board of management, general directors, deputy general directors, directors or deputy directors of enterprises established in accordance with Vietnamese law;
- Chief representatives of representative offices and directors of branch offices of foreign companies; and
- Foreign lawyers who hold a practicing certificate issued by the Ministry of Justice.

All foreign nationals working in Vietnam who do not have a work permit may be deported from Vietnam.
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