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Malaysia: The tax implications of the new Financial Services Act

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I. A landmark legislation

The Malaysian Financial Services Act 2013 (FSA) and the Malaysian Islamic Financial Services Act 2013 (IFSA), recently enacted by Parliament and expected to come into force before the end of the third quarter of 2013, will represent a landmark change to the existing regulatory landscape for financial institutions in Malaysia. The FSA effectively consolidates the Banking and Financial Institutions Act 1989, the Insurance Act 1996, the Payment Systems Act 2003 and the Exchange Control Act 1953, with the aim of introducing a more integrated approach to the regulation and supervision of financial institutions. Similarly, the IFSA will replace the Islamic Banking Act 1983 and the Takaful Act 1984, and provide a comprehensive end-to-end Shariah-compliant regulatory framework for Islamic finance in Malaysia.

Beyond the consolidation of existing piecemeal legislation that regulates various financial bodies, there is a clear policy intent to introduce and establish measures that will ensure stability in the financial sector in Malaysia, bringing it in line with financial regulation of more global and sophisticated markets. The Acts are widely considered to amount to the most significant changes to Malaysia's regulatory regime in the last 20 years.

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II. Indirect tax implications

As the main thrust of the FSA is regulatory in nature, the legislation will not result in any direct tax implications at first instance. Nevertheless, every transaction, regardless of form or scale, has a corresponding tax implication and – as will be expanded on in this article – it will become apparent that a number of regulatory requirements under the FSA are likely to hold not insignificant tax consequences for financial institutions.

In particular, it is foreseeable that certain banks and insurance companies would have to undertake corporate restructuring and other obligations in order to comply with the regulatory requirements under the FSA. It is likely that restructuring will need to take into consideration tax planning opportunities and consequences in the process of restructuring existing businesses.

III. Acquisition and disposals of interests under the FSA

The acquisition and disposal of 5 percent or more of the issued share capital of a financial institution, or of its controller, have always required the prior approval of the Minister of Finance (MOF); approval must be obtained prior to the commencement of negotiations and again before the definitive sale and purchase agreement is executed. Whilst the two-stage approval process has been retained under the FSA, going forward the approval of MOF or Bank Negara Malaysia (BNM) would only be required if:

- a proposed acquisition results in the acquirer obtaining control or holding more than 50 percent of the equity interest in the financial institution; or

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- a shareholder increases its existing shareholding in a financial institution by more than a multiple of 5 percent (e.g. a shareholder who already owns 5 percent of the shares of a financial institution may freely purchase an additional 4.99 percent of shares, after which any further increase in its shareholding would be subject to prior approval).

Similarly, disposals will only be subject to the approval of MOF if a shareholder intends to dispose of more than 50 percent of its interests or if the disposal results in the shareholder ceasing to have control over the financial institution in question.

Furthermore, the 10 percent cap on individual shareholdings in financial institutions has been retained. However, the 20 percent cap on corporations' shareholding is notably absent from the FSA.

The new and less cumbersome approval requirements for acquiring and disposing of interests under the FSA and the removal of the 20 percent cap on non-individual shareholding, is likely to be a catalyst to mergers and acquisitions in the financial sector in the coming years. As discussed in this article, insurance companies – holding composite licences in particular – are likely to have no choice but to restructure. As in most jurisdictions, share deals in Malaysia generally enjoy preferential stamp duty treatment as compared with asset transfers. Furthermore, the transfer of shares will not attract any capital gains tax liability.

Capital gains are not taxed in Malaysia, except for gains derived from the disposal of real property or on the alienation of shares in a real property company, which will be subject to tax at 15 percent or 10 percent depending on the length of ownership of the real property in question prior to disposal. Unutilised tax losses and unabsorbed capital allowances would in addition generally be retained under a share transfer, although the Malaysian Income Tax Act (ITA) does restrict the availability of unutilised loses where a substantial change of ownership occurs. Consideration should therefore be given to the tax planning aspects of the restructuring contemplated to ensure that no existing tax benefits are lost under a FSA-driven restructuring.

IV. Introduction of the financial holding company

In line with the regulation of financial institutions in more developed jurisdictions, the FSA introduces the concept of a financial holding company (FHC) for companies holding or proposing to hold more than a 50 percent equity interest in a bank or an insurer. These companies will be required to apply to BNM for approval to become FHCs. This will empower BNM to exercise oversight over financial groups as a whole and not only individual banking entities within these groups, as is currently the case under the Banking and Financial Institutions Act 1989 (BAFIA). The requirement for a shareholder to obtain approval as an FHC will only apply to companies incorporated in Malaysia; a major or controlling direct shareholder in a bank or insurer that is incorporated outside Malaysia would not be subject to this requirement. The logic behind this provision in the FSA is that foreign incorporated holding companies would already be adequately regulated in their respective home countries.

Prudential requirements applicable to banks and insurers would similarly apply to FHCs and their subsidiaries under the FSA. In addition, a FHC would have to obtain prior approval from BNM before establishing or acquiring a subsidiary, regardless of whether the incorporation or acquisition takes place within or outside of Malaysia.

In the interest of promoting financial stability, the FSA accords BNM broad-based powers to issue directions to an FHC, its subsidiaries and/or senior officers. These directions may include prohibiting or restricting proposed transactions to be entered into by any entity in the FHC's group of companies, as well as the right to direct that a capital raising exercise be undertaken by an FHC. BNM also has the ability to ring-fence the activities of a financial institution from other activities carried out by its major shareholder(s), to ensure that the ability of the latter to meet the financial requirements of a financial institution is not compromised by the risks associated with its other business activities.

Financial institutions may already be held by holding companies in the same group, which would naturally be the entities that would be required to obtain FHC status. There is also the possibility that companies that hold more than 50 percent of a financial institution may pare down their respective stakes to avoid having to apply for FHC status since FHCs would come within the purview of BNM and be made subject to regulatory requirements regarding capital, risk management and liquidity under the FSA.

For corporate groups that intend to restructure their shareholdings (e.g. to nominate another entity within the group to obtain FHC status and for this other entity to have control over the financial institution), any stamp duty liability incurred as part of the group restructuring scheme and/or amalgamation, may qualify for stamp duty exemption provided that the requisite qualifying criteria are met.

One criterion to qualify for stamp duty relief is for the transferee to be incorporated in Malaysia, or have increased its capital with a view of acquiring not less than 90 percent of the issued share capital of any particular existing company. Stamp duty relief may also be available for transfers of properties between associates where the beneficial interest in the properties are transferred from a limited liability company to another company and both companies in question are associated. In fact, it is possible that as the restructuring would have been undertaken to fulfil a newly-introduced regulatory requirement, an exemption may be available as of right, although no definitive regulation or order has been issued at this point.

V. De-mergers of composite insurers

The FSA will prohibit the carrying on of a composite insurance business (other than the exception for licensed professional reinsurers and retakaful operators). Existing composite insurers will be given five years to establish separate legal entities for their life and general businesses. This would align Malaysian insurers with their counterparts in other developed jurisdictions, and also facilitate mergers and acquisitions. A stand-alone life or general insurance company that lacks scale may result in its shareholder

> "The fact that all Malaysian companies will be transitioning to a single-tiered dividend system by the end of 2013 is an important factor to consider when planning any restructuring..."

seeking to sell-out of the business in its entirety or join forces with a stronger foreign partner.

Each de-merged insurance entity would have to ensure that it has sufficient reserves to meet the minimum capital funds requirement under the FSA. For insurance companies that already have separate reserves for both life and general businesses, capital would not be an issue. There could potentially be significant overheads for those who do not currently have separate reserves.

Where an asset transfer to a related party is contemplated in de-merging a composite insurance business, the relatively new transfer pricing and anti-avoidance provisions should be carefully examined to ensure that the allocation of purchase price to the assets to be transferred is commercially justifiable. To this end, an advance pricing agreement can be obtained from the tax authorities if necessary. The transfer of property between associated companies (90 percent control test) may benefit from a stamp duty exemption. It should also be noted that, in Malaysia, any tax incentive that is currently enjoyed by the grantee cannot be transferred to the acquirer of the asset (i.e. the life or general insurance business). If necessary, consultation with the appropriate fiscal authority may be necessary before the de-merger exercise is implemented.

Where the assets of an insurance company are to be acquired by an unrelated party, the acquirer may be able to claim capital allowances on the consideration paid for qualifying expenditure whilst the vendor may be subject to a balancing charge on the excess of disposal proceeds received over their tax written down values of assets sold, if any.

VI. Extension of BNM's powers

It is apparent from many of the amendments to be introduced under the FSA that BNM would be granted extensive discretion to monitor and scrutinise the establishment and operation of financial institutions going forward.

In addition to all the rights discussed above, the FSA would also empower BNM to assume control over whole or part of the business, affairs or property of a financial institution, manage it and/or appoint any person to do so on behalf of BNM in circumstances where BNM considers that the financial stability of the institution in question is at risk. As an alternative to winding-up, BNM may designate a bridge institution to be vested with the business, assets and liabilities of the distressed financial institution.

Furthermore, the MOF could designate financial intermediaries not under the supervision of BNM as a prescribed financial institution, where such institutions are deemed to pose a risk to financial stability. This would bring them within the purview of BNM.

When the FSA comes into force, BNM would effectively – as it is clearly intended to – have tight control over shareholding changes to and any significant merger and acquisition that is proposed to be undertaken by financial institutions. The ability of financial institutions to structure their group companies and/or to implement group-wide tax planning may be curtailed going forward, as any major merger and/or acquisition could be scrutinised by BNM and called into question if deemed not entirely necessary for the purposes of fulfilling regulatory requirements.

VII. Other tax considerations

The fact that all Malaysian companies will be transitioning to a single-tiered dividend system by the end of 2013 is an important factor to consider when planning any restructuring to meet the requirements under the FSA. Under the single-tier system, dividends are treated as tax-exempt income. Consequently, interest on loans used to finance acquisitions of shares would not be available as deductions against dividend income.

Companies may opt to push debt down to operating company levels as a result or consider offshore financing structures. The latter is permissible subject to BNM regulations, but withholding tax of 15 percent on interest paid to a non-resident will need to be taken into account where offshore financing is being contemplated, although the withholding tax rate may be reduced under certain tax treaties. Malaysia does not levy withholding tax on dividends.

Furthermore, investment holding companies currently enjoy a number of favourable tax deductions under the ITA in Malaysia, where its activities consist predominantly of the holding of investments and not less than 80 percent of its gross income is derived from such investments. It will be interesting to see if this tax treatment will be extended to FHCs under the FSA.

VIII. Conclusion

The changes introduced by the FSA and the IFSA go much further than merely consolidating the current regulatory regime for financial institutions in Malaysia. Increased prudential regulation appears to be one of the more significant thrusts of the FSA, providing for powers of BNM that in many instances go beyond those of similar regulators of more mature financial markets.

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The breadth and width of the changes introduced by the FSA appear to be in the right direction in relation to:

- the BNM's stated objectives of strengthening the legal framework for the financial sector;
- managing risks from the activities of financial intermediaries that may occur outside the banking system; and
- enhancing its powers in the event that timely intervention is required to ensure financial stability is maintained in the sector.

Furthermore, the streamlining of approval requirements for major transactions involving the acquisition and disposal of interests seem to be a step in the direction of making mergers and acquisitions in the sector more commercially viable. All of these could result in the financial sector becoming more attractive to investors, both domestic and foreign.

Nevertheless, BNM will face a challenge in convincing existing market participants that the new regime would not result in undue costs of compliance or that the almost draconian powers accorded to it under the FSA would not be misused to restrict the ability of financial institutions to plan their affairs for commercially justifiable reasons.

From a tax perspective, there are no major direct tax consequences under the FSA but the regulatory changes that require implementation will result in a number of indirect tax implications. Due diligence should be carefully carried out in any major transaction and transfer pricing guidelines properly adhered to. In any event, it may prove to be an opportunity for financial institutions to examine the soundness of their structures and in restructuring to meet the requirements under the FSA, it would be advisable that any M&A strategy includes a strong tax planning component.

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India lowers its tax rate on interest payable on debt raised overseas

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The growth rate of the Indian economy slipped last year to its lowest level in a decade. This article examines a tax concession India has introduced to help reduce its current account deficit.

India's growth rate is currently 5 percent, a far cry from the 9 percent growth in the period 2005 to 2007. Even more worrying is India's current account deficit (CAD). The Finance Minister (FM) in his Union Budget speech before the Indian Parliament on February 28, 2013 stated that his biggest concern is that India will need US$75 billion to bridge the CAD and that this could be achieved only through Foreign Direct Investment (FDI), Foreign Portfolio Investment (FII) and External Commercial Borrowings (ECBs).

In addition, India needs approximately US$600 billion over the next five years for infrastructure development. There is no doubt that the same sources will need to be tapped to fund this as well.

To facilitate and incentivise foreign flows into the Indian debt market to both finance infrastructure development and to fix the CAD problem, the FM has sought to significantly lower the tax rate that would apply to interest payable to foreign investors that seek to lend monies to Indian corporations or which seek to invest in Indian Government Securities (G-Secs), from the current 20 percent to a reduced 5 percent. This fiscal benefit that is being granted by the Indian Government is for a temporary period, the tenor of which varies depending on the investment window being accessed by the foreign investor.

The provisions for reducing the tax rate are contained in a set of two new provisions that have been introduced in the Indian Income-tax Act, 1961 (Indian domestic tax law): i.e. section 194LC (which was initially introduced in 2012 but which has only recently been activated) and section 194LD (which was introduced in 2013). This article, presents a critique on these new tax provisions and sheds some light on the opportunities and challenges they bring for foreign investors seeking to explore this window of opportunity.

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I. Section 194LC: foreign currency debt

Broadly speaking, the Indian tax laws set out distinct provisions relating to:

1. the levy of tax on non-residents;
2. the collection of such tax through a system of tax withholding by the payer;
3. the need for the non-resident to get itself registered with the Indian Revenue Authorities (IRA) by procuring a tax registration number, which is colloquially referred to as a Permanent Account Number (PAN), should the non-resident wish to avail of any concessional tax rates at the time of tax withholding; and
4. the need for the non-resident to file an annual tax return in India with the IRA, at the end of the Indian financial year, which runs from April 1 to the following March 31.

Section 194LC is a withholding tax provision. It states that an Indian corporation that pays interest to a non-resident on "monies borrowed" by it from the non-resident, during the period July 1, 2012 to June 30, 2015 (the eligible period), in foreign currency and from a source outside India either:

- under a loan agreement; or
- by way of issue of long-term infrastructure bonds (LTIB),

shall withhold tax on such interest at the rate of 5 percent on a gross basis. The tax withholding applies at the time of payment or credit of such interest to the account of the non-resident, whichever is earlier. The provision comes with two riders, inter-alia, that (i) the borrowing by the Indian corporations, and (ii) the quantum of interest payable on such a loan, are to be approved by the Indian Government.

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Correspondingly, the Government amended the provisions relating to the actual levy of tax on non-residents to synchronise it with the tax rate that is specified in the withholding tax provision. Therefore, the tax law clearly states that non-residents granting loans to Indian corporations would be levied a final tax of 5 percent on the interest income they earn from such corporations and that the borrower company would discharge this tax liability for the non-residents by way of withholding tax on the interest payouts.

Furthermore, the Government has also amended the provision relating to mandatory quoting of PANs to avail of the concessional withholding tax rate, by allowing Indian corporations to extend the concessional tax rate to those foreign investors who have invested in foreign currency denominated LTIB that are issued by an Indian corporation even though the foreign investor may not have procured a PAN.

However, the need for mandatory quoting of a PAN by the foreign investor to avail of this concessional tax rate still remains for those foreign currency borrowings which are done under a normal loan agreement and which are not LTIBs. In both the above situations (i.e. dealing with borrowings by way of a loan agreement or by way of LTIBs), if interest is the only Indian sourced income for the foreign investor and taxes have been properly withheld at source by the Indian corporation, then the foreign investor is exempted from filing an annual tax return with the IRA at the end of the Indian financial year.

Having said that, there are several anomalies in the new legislation which are currently being grappled with by both Indian corporations as well as foreign investors, who are keen to explore this window of opportunity.

A. Operational considerations

(i) The need for the Indian corporation to obtain prior Government approval each time it raises foreign currency debt to secure the 5 percent tax rate.

This requirement potentially brings about a great administrative and operative burden on Indian corporations raising the foreign currency debt. Realising this, the Indian Government, through the Central Board of Direct Taxes (CBDT)[1] issued a circular[2] clarifying that any borrowings complying with the following conditions would be treated as automatically approved by the Indian Government for the purposes of section 194LC:

1. Borrowings made, whether by way of a loan agreement or issuance of LTIBs, must be permitted under the ECB framework of the Reserve Bank of India (RBI)[3], additionally:

2. For loans:

- The borrowing should not be used to restructure an existing loan being undertaken solely to take benefit of the reduced withholding tax rate.
- No part of the borrowing should have occurred prior to July 1, 2012.

3. For LTIBs:

- The bonds should be issued for a minimum period of three years.
- The proceeds should be used only in the "infrastructure sector", as defined by the RBI in the ECB policy.

Borrowings that do not comply with the above conditions require prior Government approval to be eligible for the concessional tax rate. The Indian Government would consider granting such approvals on a case-to-case basis. With this circular, the procedural aspects were made fairly clear. The issues, therefore, now remain only with respect to certain technical interpretations of section 194LC.

B. Interpretational considerations

(i) What is meant by "monies borrowed"?

The term "monies borrowed" is not specifically defined in Indian domestic tax law. Furthermore, the circular imposes certain additional conditions, such as (i) no part of the borrowing should have taken place under the loan agreement before July 1, 2012; and (ii) that restructuring of existing loans being undertaken solely to avail of the reduced withholding tax rate will not be permitted. Therefore, the drafting of the provisions could raise various potentially questions. For example:

- Which date needs to be considered for granting the concessional tax rate, i.e. the date of the loan agreement / the actual sanction of the loan or the date of actual drawdown of the loan?
- What happens if the loan is structured in a manner such that the drawn down takes place in multiple tranches, some prior to July 1, 2012 and some during the eligible period?

Depending on the answers to these questions, a particular borrowing could either be eligible or ineligible for the reduced tax rate.

Therefore, interpreting the term "monies borrowed" gains significant consideration. Based on judicial precedents in India – though issued in a different context – it appears that the term "monies borrowed" ought to be interpreted to mean that there must exist a debtor-creditor relationship between two parties to constitute "monies borrowed" between them. In our view, mere signing of a loan agreement or sanctioning of a loan would not create such a relationship: such acts would only finalise the terms based on which a lender agrees to provide financial support to a borrower. These terms have no significance if there is no actual borrowing. Furthermore, in our view, every draw down should be treated as independent "monies borrowed", starting from the date of the actual draw down and interest on such tranches of borrowing should be computed from that date onwards.

Hence, it is this act of drawing down of a loan that ought to be treated as "monies borrowed" for the purposes of this section. Consequently, only those loans that are drawn down during the eligible period should be eligible for the concessional tax rate. Additionally, even new tranches that are being drawn down of an existing loan (that exist as on July 1, 2012) and which are drawn down during the eligible period ought to be eligible for the concessional tax rate. The fact that the circular provides that no part of the borrowing should have taken place under the agreement before July 1, 2012, should, in our view, be interpreted to mean that the concessional tax rate cannot be applied to those tranches of the loan agreement that were drawn down prior to July 1, 2012. This provision of the circular should not be interpreted restrictively to mean that only those loans that are drawn down entirely (i.e. with no single tranche being drawn down prior to July 1, 2012) during the eligible period would qualify for the concessional tax rate; this is because such a restriction is not provided for in section 194LC, and a circular cannot restrict / override the provisions of the law.

> "...the new tax provisions appear to be pro foreign investment..."

Indian corporations that restructure existing foreign currency loans for proper commercial reasons, such as varying the tenor of the loan or reducing the corporations' borrowing costs etc., should be able to extend the concessional tax rate of 5 percent to their foreign lenders (for such loans being restructured during the eligible period). Both, the Indian corporation and the foreign investor will need to be able to prove that the Indian corporation did not restructure its existing foreign currency loan, purely to extend the concessional 5 percent tax rate to the new foreign investor. Hence, it is advisable for foreign lenders that are engaging in such restructuring / refinancing arrangements to negotiate properly with the Indian corporation to satisfy themselves that the restructuring / refinancing is not being undertaken solely by the Indian corporation to extend the concessional tax rate to the foreign investor. Refinance transactions that are done properly can be executed with the same foreign investor.

(ii) For how long will this tax benefit be available?

There is no time limit. So long as the money is borrowed by the Indian corporation during the eligible period, the interest payable on such borrowing ought to be eligible for the concessional tax rate throughout the tenor of the borrowing. Therefore, a 10-year loan taken during the eligible period should enjoy this concessional tax rate on all interest payouts over the entire life of the loan. This is obviously subject to there being no change made in the Indian domestic tax law in the future.

C. What are the practical difficulties faced by foreign investors in seeking the concessional tax rate?

(i) Withholding tax versus final tax of non-residents

The Indian tax system which provides a withholding tax obligation on the payer and separately sets out a tax levy on the recipient of income sometimes creates unnecessary complications for both parties. More often than not, payers in India tend to be extremely conservative when withholding tax on payments made to non-residents, as the consequences of an erroneous tax withholding could be severe interest and penalty obligations devolving on the payers.

Given that there could be some level of interpretation required in certain instances – as we have discussed in the above paras – to be eligible for the concessional tax rate, an Indian corporation may choose to be cautious at the time of undertaking the tax withholding, by insisting on not granting the non-resident the concessional tax rate benefit and by withholding tax at the normal rates prescribed in the Indian domestic tax law (which is currently 20 percent) or the applicable tax treaty rate (if any). In such a situation, all is not lost for the non-resident. The non-resident can claim a tax refund from the IRA for the excess tax withheld by the Indian corporation, by filing a tax return in India with the IRA.

While technically the non-resident does not go out-of-pocket on an aggregated basis for the excess tax withheld by the Indian corporation, it does create a series of problems for the non-resident: such as a liquidity issue, a timing issue and a currency risk issue. This is because the non-resident will receive its income-tax refund from the IRA in Indian Rupees (INR) after a few years. On the flip side, in case of a tax protected loan contract, the Indian corporation may choose to adopt a more aggressive position at the time of tax withholding and see how the issue of eligibility to the concessional 5 percent tax rate will play out with the IRA, after all, in such a case the Indian corporation may need to foot the final Indian tax bill of the non-resident. Given the manner in which cross-border financing agreements typically get negotiated by Indian corporations – especially in the context of tax protected contracts – it is important for the foreign investor to negotiate the terms of tax protection properly, so as to avoid any tax risks devolving on it at a future date on account of short tax withholding by the Indian borrower.

(ii) Only foreign currency debt and not INR debt is covered

A significant drawback of section 194LC is that it grants the benefit of the concessional tax rate only to borrowings denominated in foreign currency. A large amount of cross border debt, especially in the nature of hybrid debt that are taken by Indian corporations in INR – for example, Fully Compulsorily Convertible Debentures (FCCDs) – fall outside the purview of this section, merely because the liability is not recognised by the Indian corporation as a foreign currency liability. Hence, if the Indian Government is unable to fix the CAD issue soon, it may wish to consider extending the concessional 5 percent tax rate benefit, even to cross-border-hybrid-INR-denominated debt that is raised by Indian corporations.

II. Section 194LD: debt investments by Foreign Institutional Investors / Qualified Foreign Investors[4]

Portfolio investors, such as Foreign Institutional Investors (FIIs) play a pivotal role in the growth, development and strengthening of the Indian capital markets. The Indian capital markets have predominantly comprised of the equity markets; though a lot needs to be done to grow and strengthen the Indian debt markets (IDM). Most investors in the IDM comprise of institutional investors, particularly domestic institutions such as local banks, non-bank finance companies, mutual funds and insurance companies; some of the foreign investors that participate in the IDM include FIIs.

Section 194LD is aimed at providing tax relief to FIIs and Qualified Foreign Investors (QFIs), who invest in Indian corporate debt securities and G-Secs; much like how section 194LC offers such tax relief to foreign investors who lend to Indian corporations under the ECB window. The broad construct of section 194LD is similar to that of section 194LC, in as much as it is a withholding tax provision that extends the concessional 5 percent tax rate to FIIs / QFIs who invest in certain Indian securities, subject to certain conditions. The Government has correspondingly amended the other provisions in Indian domestic tax law that deal with the taxability of FIIs / QFIs so as to synchronize them with the withholding tax provisions.

Specifically, section 194LD provides that any person responsible for paying interest to a FII / QFI shall withhold tax from the interest payable, at the time of payment or credit, whichever is earlier, at a concessional rate of 5 percent on a gross basis. The concessional tax rate applies to the following:

- interest payable on or after June 1, 2013 but before June 1, 2015 (the relevant period);
- such interest should be in respect of an investment by a FII / QFI in:
  - an INR denominated bond of an Indian corporation, provided that the rate of interest does not exceed the rate as prescribed by the Central Government in this behalf;
  - a G-Sec.

The Central Government is yet to notify the rate of interest discussed above.

This section, though similar in nature to section 194LC, is materially different from it in various ways. For example, (i) it applies only to a certain class of non-residents, ie FIIs and QFIs; (ii) it does not appear to concern itself with when the bond or G-Sec was issued[5], but only the period during which the interest is payable; and (iii) it covers foreign investment in INR denominated debt paper.

While we still await a Government notification which would clarify which types of INR denominated bonds could potentially be covered, and to what extent the interest paid on such bonds would be eligible for the concessional tax rate, there are various technical issues around this section that merit discussion.

A. What is meant by "interest payable"?

The provision applies to "interest payable" during the relevant period. The issue at hand would be best understood by an illustration. Let us assume that there is a bond which pays interest annually amounting to INR 12. The last interest was paid on July 1, 2012 and the next interest installment is due on July 1, 2013. Would the entire interest of INR 12 payable on July 1, 2013 be eligible for the concessional tax rate of 5 percent? Or, would only that portion of the interest which accrues after June 1, 2013 (i.e. the date mentioned in the new section 194LD) amounting to INR 1 be eligible for the concessional tax rate, while the interest which accrues for the months of July 1, 2012 to May 30, 2013, attract the normal tax rate of 20 percent or the applicable tax treaty rate (if any)?

In India, courts recognise the difference between the legal principle of "accrual" from the accounting principle of "accrual". From a legal perspective, interest "accrues" when it is "due" or "payable". Accounting, on the other hand, which works on the principle of conservatism, requires the recording of expenses in a timely manner over a period of time, such that all expenses are adequately provided for when they become "due" or "payable". This gives rise to the recording of interest expenses in the hands of the Indian issuer company periodically, by following the "accrued and due concept" and "accrued but not due concept".

Based on judicial precedents in India, for tax purposes, the legal concept is what is relevant: not the accounting principle. Therefore, interest is "payable" when it is "due", not before that. Prior to the date on which the interest becomes "due", the lender has no right to demand any interest from the borrower; hence, until the due date nothing is "payable". Therefore, in the above example, there could be a good case for an FII / QFI to contend that the entire interest of INR 12, which is receivable on July 1, 2013 and which covers the period July 1, 2012 to June 30, 2013, ought to be eligible for the concessional tax rate. This would be subject to the terms of issue of the bond and what rights the parties have against each other, as regards when the interest is payable.

On the same facts and for the same bond, in calendar 2015, the interest that will be payable to the FII / QFI on July 1, 2015 and which will cover the period July 1, 2014 to June 30, 2015 will attract the normal tax rate of 20 percent applicable to FIIs / QFIs or the applicable tax treaty rate (if any). Hence, the axe could swing in the opposite direction in 2015. Whether the Indian Government will extend the concessional tax rate of 5 percent to FIIs / QFIs beyond the relevant period is something that one will need to wait and watch for in future years.

B. Does the structure of the bond itself have any relevance?

Bond issuances can be structured in various ways depending on what is acceptable to the borrower and the lender. For example, bonds that are:

- issued at par and redeemed at par, and which carry an interest coupon;
- issued at a discount and redeemed at par;
- issued at par and redeemed at a premium;
- have a combination of the above features.

Under Indian domestic tax law, the term "interest" is defined very broadly to cover not only the interest coupon payable on a bond, but also the discount on issue and premium on redemption of the bond. However, Indian courts do recognise that in case of debt securities that carry an interest coupon and which also pay a premium over the issue price of the bond, there is a difference between why the lender earns a return by way of "interest" and why the lender earns a return by way of "premium" on redemption of the bond; that the two streams of income that arise to the lender are different and hence ought to be taxed separately.

There appears to be a case for Indian corporations to structure their bond issuances to FIIs / QFIs, which have the above features, which could enable the FIIs / QFIs claim the concessional tax rate of 5 percent on the interest income, while a tax exemption for capital gains arising on redemption of the bond (assuming the FII / QFI were entitled to claim such tax exemption benefits under a tax treaty). It would be good if the Indian Government could clarify the above treatment and whether the interest cap that is to be notified by it on bonds that are eligible for the above concessional tax rate, should consider all payouts on the bond or only the interest coupon payable on the bond.

C. Bonds versus debentures, is this going to be a problem?

Strictly technically, there is a legal difference between a "bond" and a "debenture". This difference is recognised in Indian corporate law, Indian securities law etc. Even the Indian domestic tax law recognises "bonds" and "debentures" to be separate, especially in other sections that are codified in the law. The regulations governing FIIs and QFIs also mention the two terms separately. All these imply that the two terms are different and cannot be used inter-changeably. This would, unwittingly, imply that the provisions of section 194LD apply only to "bonds" issued by Indian corporations; not "debentures".

FIIs and QFIs have historically invested in non-convertible debentures (NCDs) issued by Indian corporations, and hence there is a question mark on whether interest payable by an Indian corporation on NCDs issued to FIIs / QFIs would be eligible for the concessional tax rate in the first place. While the legislative intent does not appear to keep "debentures" outside the purview of section 194LD, it would be good if the Indian Government were to clarify its position in this regard, to avoid unnecessary litigation with the IRA on this very technical issue.

D. What could be some of the practical challenges that FIIs / QFIs may face while trying to access this concessional tax rate?

Section 194LD comes into effect from June 1, 2013. However, there is lack of clarity on all the above mentioned issues. Even the press release that was issued by the Indian Government on May 21, 2013 does not address the above issues. Hence, until there is clarity on the above points, some Indian corporations may adopt the conservative approach of withholding tax at the normal tax rate of 20 percent or the tax treaty rate (where it is applicable), while making payments to FIIs / QFIs. The FIIs / QFIs would be free to adopt their own positions with regard to their eligibility for the concessional tax rate of 5 percent under section 194LD, when they file their respective tax returns with the IRA at the end of the financial year. However, this would mean that the FIIs / QFIs would have to claim tax refunds from the IRA, on account of surplus taxes that may have been withheld by the Indian corporations, which could create the same liquidity issue, timing issue and currency risk issue as we discussed in the context of cross-border lending that is done in foreign currency.

III. Conclusion

Both the new tax provisions appear to be pro foreign investment and appear to extend the concessional tax rate of 5 percent to foreign investors fairly unambiguously. However, regardless of the intent behind the legislation, the legal drafting of the law has created some ambiguities, which need to be clarified on a priority basis, should the Indian Government wish this temporary window of opportunity be used successfully by foreign investors, and which will also help India fix its CAD problem.

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NOTES

[1] The CBDT is the apex tax administration body in India. It is part of the Department of Revenue which is housed within the Ministry of Finance.

[2] Circular 7/2012 dated September 21, 2012

[3] The RBI is the Central Bank of India. In addition to formulating and administering the monetary policy of the country, the RBI helps the Government, inter-alia, in managing the country's foreign exchange reserves. The RBI sets out detailed guidelines which provide for the conditions on the back of which an Indian corporate is permitted to raise foreign currency loans either under the automatic route, or pursuant to a specific approval from the RBI.

[4] QFIs represent a new class of foreign investors that were recently allowed to invest into Indian debt securities and equities. QFIs do not require a prior registration with the Securities and Exchange Board of India (SEBI) to be eligible to invest in Indian securities, unlike how FIIs do. QFIs are merely required to establish a relationship with certain custodian banks in India and complete KYC procedures to commence investing in India.

[5] This has specifically been clarified in a press release issued by the Government on May 20, 2013.

Australia's budget 2013: the tax implications

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On May 15, the Australian Budget was announced. This article identifies and details the main components of the budget.

I. Introduction

In handing down the 2013–14 Federal Budget, Treasurer Wayne Swan blamed a stubbornly high Australian dollar and lower commodity prices for a dramatic fall of some AUS$17 billion in forecasted tax receipts, leading to an estimated budget deficit for 2012–13 of AUS$18 billion.

This is obviously a far cry from the 'on time, as promised' budget surplus of AUS$1.5 billion that he announced in the last budget.

In stating that the Government was "charting a sensible pathway to surplus over the forward estimates," Mr Swan said that he expected a reduced deficit of AUS$10.9 billion in 2014–15, breakeven in 2015–16 and a return to a modest budget surplus in 2016–17. The forecast for economic growth in 2013–14 is 2.75 percent (revised down from the previous forecast of 3 percent) and in 2014–15 the economy is expected to grow by 3 percent. The unemployment rate is expected to increase slightly from 5.5 percent to 5.75 percent by June 2014.

Being in no position to provide any pre-election handouts the Treasurer, instead, announced a cut to a range of benefits to middle income families, deferred previously announced tax cuts, a scrapping of the AUS$5,000 baby bonus and an increase in the Medicare Levy of 0.5 percent in order to fund the National Disability Scheme.

On the tax front, it seems that the Treasurer is intent on driving increased tax revenues through a range of tax integrity measures, rather than through any structural changes designed to promote business growth and make Australia more competitive.

To that end, the Government has announced a range of measures that are targeted at addressing tax base erosion and profit shifting by multinationals through loading a disproportionate amount of debt to Australia, including a tightening to Australia's Thin Capitalisation rules, being rules that seek to limit the amount of debt deductions that can be claimed as a tax deduction against income in certain circumstances.

The only tax concession provided for business in the Budget is the increase in the thin capitalisation *de minimus* threshold from AUS$250,000 to AUS$2 million of debt deductions. However, we await clarification from the Treasury that this increase is not limited to small business.

Other significant tax measures include the introduction of a 10 percent non-final withholding tax for non-residents that dispose of Australian real property, with the exception of residential property less than AUS$2.5 million in value. The definition of Taxable Australian Real Property (TARP) as it relates to mining assets will also be changed to include mining, quarrying or prospecting information, and rights to such information and goodwill, which are currently not subject to tax if disposed of by a non-resident.

Not unexpectedly, Mr Swan also announced an integrity measure to prevent 'dividend washing' by sophisticated investors who buy and sell shares that carry dividend rights in order to access two lots of dividend franking credits in respect of essentially the same shares.

Following a recent Board of Taxation report, the Budget contained measures to close a number of loopholes in the tax consolidation regime. Of the 26 recommendations made by the Board of Taxation in its review of the tax consolidation provisions, only 4 have been adopted by the Government. Interestingly, they are all integrity measures.

The Budget also contained the changes to the superannuation rules that were previously announced by the Government on April 5, 2013. Broadly speaking these relate to a rebating of the penalties that apply to excess contributions, an increase on the cap for deductible superannuation contributions for those aged above 50 and 60 respectively, and the taxing of superannuation fund earnings where they exceed AUS$100,000 per year per member.

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As with many previous Budgets, additional funding has been provided to the Australian Taxation Office (ATO) over four years to improve compliance by Australian taxpayers through expanding data matching with third party information, and also to enable the ATO to establish a taskforce designed to target trusts that conceal income, mischaracterise transactions, artificially reduce trust income and underpay tax.

However, with the election looming in September of this year, it ultimately remains to be seen just how many of the Budget announcements will see the light of day.

II. Corporate

A. Tax consolidation changes

(i) Board of taxation review and recommendations

The Government released two reports from the Board of Taxation (the Board) which contained 26 recommendations for improving the consolidation regime, including recommendations to simplify consolidation for small businesses. Of all the Board's recommendations, only 4 were adopted by the Government, all of which were integrity measures.

(ii) Small business concessions

The Board recommended a number of significant improvements to the tax consolidation regime that would address the current inequities for small business. The recommendations included:

- Mitigating the complexity and costs of the current group formation rules by allowing a group to retain their existing tax cost bases and utilise existing losses.
- Providing micro-SMEs with alternative tax grouping rules outside of tax consolidation.
- Facilitating group restructures into tax consolidated groups.
- Correcting the tax consolidation rules so that they apply appropriately when interacting with the various capital gains tax and trust provisions.

We note that the Board's reports acknowledged the substantial improvements delivered to the corporate tax system by the consolidation regime, a sentiment with which the Government itself has agreed.

However, without exception, the Government has neglected to adopt the above recommendations that could assist approximately 25,000 small business groups, of which 18,000 are still not consolidated.

Based on the recommendations, we would be surprised if any of these measures for the middle market would present a revenue cost for the Government. In particular, these recommendations were aimed at simplifying compliance for this sector. This was a clear opportunity for the Government to make a statement in support of the middle market. The failure to act on these proposals is both difficult to explain and disappointing.

(iii) Assessing liabilities for new joining entities

The Government has accepted the Board's recommendation to assess the value of tax deductible accounting liabilities that an entity has on joining a tax consolidated group. This means that if the entity had (for example) a provision for annual leave of AUS$100, the head company will now be taxed on AUS$100 on the subsidiary entity joining the group. This removes the current double benefit that occurs when there are deductible liabilities. The Budget states that this measure will apply to transactions after May 14, 2013. This represents a clear watch-out for acquisitions and formations of a tax consolidated group after May 14, 2013. Taxpayers and advisors will need to take this significant change into account when performing their transaction calculations. Unfortunately, very few details have been provided on this measure, making it difficult for taxpayers to assess the exact impact of this measure.

(iv) Introducing integrity measures

The three remaining integrity measures which were announced deal with:

- value shifting within a consolidated group;
- transfers of assets from non-residents to controlled tax consolidated groups; and
- adjustments to the Taxation of Financial Arrangements (TOFA) regime.

These announcements also apply from May 14, 2013. The Government has also announced a review of the provisions dealing with multiple entry consolidated (MEC) groups.

III. International tax

In response to growing fears of an eroding tax base and claims of threat to national sovereignty, the Government has pushed ahead with some of the biggest changes to Australia's international tax regime in recent times. This will have significant implications for taxpayers with inbound and outbound structures and international dealings.

A. Abolition of interest deductions incurred in deriving foreign dividend income

The Government has announced the repeal of the provision which currently allows a deduction for interest expenses incurred in deriving non-assessable non-exempt foreign non-portfolio dividend income, with effect from July 1, 2014.

A similar change will also be made to the equivalent provision within the Taxation of Financial Arrangements regime.

B. Changes to foreign non-portfolio dividend exemption

There is currently a tax exemption for dividends paid by a foreign company to an Australian company which holds shares that grant at least 10 percent of the voting power (referred to as non-portfolio interests).

The Government has announced that it will be proceeding with the reform of the relevant provision, a change which was originally flagged in the 2009–2010 Budget. These reforms will be included in the

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consultation process on the thin capitalisation changes. However at this stage it would appear that the changes will not apply until July 1, 2014.

C. Extension to dividends received via trusts and partnerships

A welcome, albeit previously announced, change to the non-portfolio dividend exemption provision is the extension of the exemption to Australian companies that receive foreign non-portfolio dividend income through an investment in a fixed trust or partnership.

This amendment should assist where nominee arrangements are in place, which can be necessary in some countries due to foreign ownership restrictions. However, we would hope that the final legislation would extend to dividends derived via all trusts.

> "...the Government has pushed ahead with some of the biggest changes to Australia's international tax regime in recent times."

D. Proposed tightening of the thin capitalisation regime

The Government has announced a number of measures intended to tighten and improve the effectiveness of the thin capitalisation rules. Effective from July 1, 2014, these measures include:

- Increasing the current *de minimis* threshold from AUS$250,000 to AUS$2 million of debt deductions;
- Reducing the safe harbour debt-to-equity ratio from 3:1 (i.e. 75 percent of gross assets) to 1.5:1 (i.e. 60 percent of gross assets);
- Reducing the worldwide gearing test ratio from 120 percent to 100 percent for outward investors and extending the worldwide gearing test to inward investors.

In addition, the Government has announced that it will retain the arm's length debt test. The Government will seek to reduce compliance costs for taxpayers who adopt this test and make the test easier for the (ATO) to administer. The Government has referred this issue to the Board of Taxation for consultation.

E. Withholding tax on disposal of TAP assets by foreign residents

From July 1, 2016, the Government will introduce a foreign resident withholding tax regime on the sale of certain Taxable Australian Property (TAP) assets.

A 10 percent non-final withholding tax will apply to the disposal of such assets by foreign residents. The purchaser will be required to withhold and remit 10 percent of the sale proceeds to the ATO. The disposal of residential property will only be caught by the new rules where the sale is more than AUS$2.5 million.

F. Changes to the capital gains tax regime for foreign residents

The Government has announced that it will make several changes to improve the integrity of Australia's capital gains tax regime as it applies to non-residents.

Currently, non-residents are subject to capital gains tax on the disposal of TAP. TAP includes:

- direct interests in Australian real property and mining, quarrying or prospecting rights (TARP);
- membership interests in an entity where more than 50 percent (by value) of the entity's assets are TARP (directly or indirectly).

The Government has identified that the current principal asset test may allow opportunities for indirect interests held by non-residents to fall outside the TAP definition, as follows:

- Through the generation of intercompany dealings between entities in the same tax consolidated group which have the effect of diluting the TARP percentage of a group.
- By excluding intangible assets (such as mining information and goodwill) connected to mining, quarrying or prospecting rights from the value of the TARP thus reducing the TARP percentage of a group.

The Government has proposed amending the principal asset test to address these perceived deficiencies with effect for disposals on or after 7.30pm AEST on May 14, 2013.

While the proposed rules appear to better reflect the initial intention of the capital gains tax regime, we are keen to review the legislation to ensure that there are no unintended consequences.

We are also concerned that any delay in drafting legislation for these proposed changes will create uncertainty for non-resident taxpayers.

G. Further deferral of CFC reforms

The Government has announced that previously announced reforms to the Controlled Foreign Company (CFC) will be deferred and reconsidered after the OECD completes its analysis with respect to base erosion and profit shifting.

The Government has previously acknowledged that the CFC reforms would reduce the incentive for businesses to adopt aggressive restructuring arrangements to shift profits, and reduce compliance costs for affected Australian businesses, ensuring that they remain competitive in global financial markets.

However, the Government appears reluctant to implement these changes which were originally announced in the 2009–10 Federal Budget, and identified by the ICAA in its September 2012 submission to the Treasury as a priority tax policy issue.

As it has been more than two years since the last round of consultations for this reform, it begs the question as to how long the business community will have to wait for these priority changes to not only be legislated, but also to take effect.

We note with interest that the UK has recently revamped its CFC rules with the goal of creating a more competitive and modern CFC regime, even in the midst of the considerable global debate on cross-border tax planning issues.

The OECD is due to deliver an initial comprehensive action plan to address base erosion and profit shifting issues by June 2013.

H. International compliance activities

(i) AUSTRAC

The Australian Transaction Reports and Analysis Centre (AUSTRAC) will be given additional funding to counter money laundering, major crime and tax evasion. Taxpayers need to be aware that AUSTRAC has the ability to monitor all international fund transfers, irrespective of the value involved. This information is used by the ATO and other Government agencies to create a more complete picture of the business affairs of taxpayers, and can be provided to international tax authorities via Australia's network of information exchange agreements.

We have seen such information prompt a number of ATO reviews and audits. This is, therefore, a timely reminder for taxpayers to review their arrangements to ensure that they are properly complying with their Australian tax obligations with respect to any foreign holdings or transactions.

(ii) Transfer pricing

The Government will provide additional funding for the ATO to increase compliance activity targeted at restructuring activity that facilitates transfer pricing opportunities. With the information provided to the ATO by the new International Dealings Schedule, and the extended powers given by the proposed amendments to the transfer pricing rules, the ATO will be in a strong position to challenge pricing methodologies adopted by taxpayers for their internationally-related party dealings.

This is another area where taxpayers should expect an increased level of scrutiny, and thus should ensure that their transfer pricing documentation is both contemporaneous and robust.

IV. Mining and exploration

A. Limiting immediate deductibility of exploration expenditure

The Government has announced that it intends to tighten the tax rules under which expenditure incurred on mineral exploration or prospecting can qualify for an immediate deduction.

Specifically, it is proposed that expenditure to acquire mining rights and information will in certain cases only be deductible over the shorter of either 15 years or the life of the mine, quarry or petroleum field to which it relates.

The intent of the proposed changes is to limit immediate deductions for such rights and information to parties which are undertaking so-called "genuine exploration" – i.e. parties which are themselves participating in, and assuming the risks relating to, mineral exploration activity.

For these reasons, it is proposed that immediate deductibility will be limited to mining rights and information where an entity:

- incurs costs in generating or improving the information itself;
- acquires the rights under a farm-in, farm-out arrangement;
- acquires the rights or information from a relevant government authority.

Immediate deductions will continue to be available in relation to depreciating assets first used for exploration and, in practice, explorers would generally still be entitled to immediate deductions for exploration which they themselves conduct.

While not specifically targeted at junior explorers, these changes still have an indirect impact on this sector. The market value of any rights and information generated by junior explorers (and, by extension, the market value of these exploration companies themselves) is likely to be reduced given the loss of the immediate depreciation benefits that previously attached to such assets.

It is proposed that these changes will take effect immediately, although exceptions do exist for taxpayers who are already committed to acquiring such rights or information or are already taken to hold such rights or information.

V. Transaction taxes

A. Goods and services tax

As expected, this year's Budget does not contain any significant changes to the GST. Disappointingly however, the Budget remains silent on when the previously deferred measures implementing the recommendations of the Board of Taxation, which were intended to reduce the GST compliance costs of taxpayers, will be put back on the reform agenda.

(i) GST instalment system

The Budget contains only one change to a measure announced in the 2011-12 Budget in relation to the extension of the GST instalment system to small taxpayers in a net refund position. The measure confirms the Government's previous announcement on November 5, 2012, being the time Exposure Draft legislation was released, that the measure had been revised to allow only those businesses already participating in the GST instalment system to continue to use the system if they move into a net refund position.

This year's Budget confirms that the revision was made as a consequence of concerns identified that the original measure may present a revenue risk and could be in conflict with other initiatives designed to target non-compliance in particular sectors of the economy. The measure will have effect from the date of Royal Assent of the Exposure Draft legislation which was introduced into Parliament on March 20, 2013.

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(ii) Board of Taxation review

After significant announcements in the 2009 and 2010 Budgets proposing to implement various recommendations of the Board of Taxation aimed at reducing taxpayers' GST compliance costs, many of which were indefinitely deferred in the 2011 Budget, we have not seen the re-emergence of any of those measures in this year's Budget.

In particular, changes to the GST grouping membership rules to allow "closely connected" entities to form a GST group would have been of significant benefit for our clients who operate their businesses through trusts and who could benefit from the ability to form a GST group in order to increase compliance efficiency.

The long-awaited clarification regarding the GST treatment of tax law partnerships would have also been welcome, particularly given that they give rise to difficult GST issues in relation to real property transactions.

B. Customs and excise

(i) Excise on tobacco products

For those with long memories when the typical Budget headline was "Smokes, Booze and Petrol Up", the latest changes to excise on tobacco products has a ring of nostalgia about it. The Government intends to change the way in which the excise imposed on tobacco products is indexed in the future.

Rather than continuing to link the increases in excise to movements in the Consumer Price Index (CPI), the Government will in future index the excise on tobacco and tobacco products based on movements in Average Weekly Ordinary Time Earnings (AWOTE). The Government states that this will ensure that tobacco excise keeps pace with incomes. As with the current CPI indexation, the AWOTE based indexation will occur bi-annually.

As an added bonus for the States, this measure will also result in an increase in the GST collected on tobacco and tobacco products. Based on historical data, it is expected that the change in indexation methodology will result in an increase of 7 cents for the cost of a typical packet of 25 cigarettes in early 2014.

For confidentiality reasons, the Government has declined to publish details of the expected revenue gain from this measure.

VI. Tax compliance

The Government has announced increased funding to support further activity in the areas of administration and compliance. Over AUS$220 million has been set aside for the Australian Taxation Office (ATO) to pursue initiatives in respect to Australian Business Register (ABR) and Australian Business Number (ABN) administration, trust compliance and data matching.

A. Enhancing ABN and ABR administration

It is proposed that the ATO and the Department of Finance and Deregulation will strengthen up-front checks for issuing ABNs and further promote the online service of the Australian Business Register. The Government has allocated some AUS$80 million to this initiative for a purported revenue saving of AUS$100 million and reduced compliance costs for taxpayers.

B. Taskforce to target trusts

The Government will provide AUS$67.9 million to the ATO over four years to undertake compliance activity in relation to the announced trusts taskforce. The Government claims that this initiative will increase revenue by AUS$379 million.

C. Improving compliance through third party reporting and data matching

The Government will provide the ATO with AUS$77.8 million over four years to improve compliance by expanding data matching with third party information. This will cover not only domestic activities but extend to Austrac reported transactions. This is the highest return compliance measure identified by the Government with estimated revenue gains of AUS$610 million over the forward estimates period.

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VAT is a major source of risk and opportunity in China

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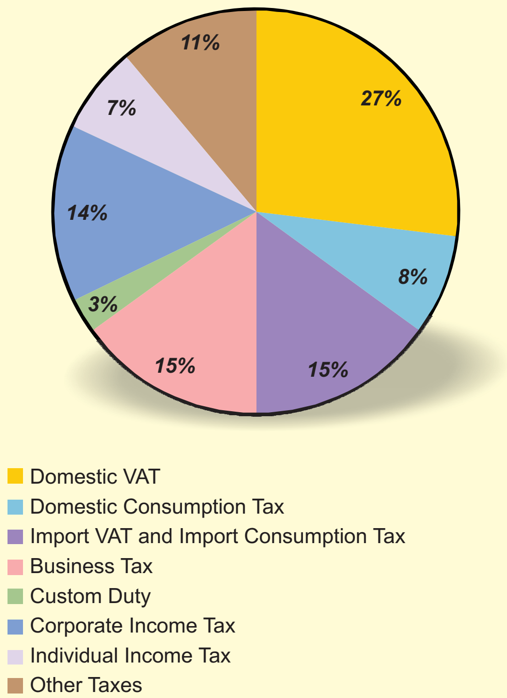
VAT is an important component of the Chinese Government's tax regime, as the share of tax revenue coming from VAT is higher than in many developed countries around the world.

Based on figures from the Ministry of Finance for the year 2011, China collected more than one third of its entire tax revenue in the form of VAT. The Chinese Tax Bureau (CTB) collected over 27 percent on domestic transactions and approximately another 8–10 percent is collected by Chinese customs on imported goods.

Companies and consumers in China are paying significant amounts of VAT. On top of that, China's VAT rules differ from many other countries and the system is in a constant state of change.

VAT, in theory, is seen to be a neutral pass through tax that only moves across the balance sheet of a company's financial statements and does not impact the bottom line. In principle, VAT is passed through by offsetting input VAT, paid by the company to suppliers and/or customs, against output VAT collected from customers. For export-oriented entities, they would apply for a refund of the input VAT paid since there is little, or no, domestic sales and such transactions do not charge output VAT.

Figure 1: China tax revenues in 2011



Note: import VAT and import consumption tax are collected by China Customs and are not broken out in the MoF statistics.

I. The cost of Chinese VAT

It is a myth that Chinese VAT is simply a cashflow item with no profit and loss impact and a limited risk profile. On closer examination, VAT in China is far from neutral with "sticking" VAT, blocked input credits, cascading costs and other unique technical matters which can result in significant VAT-related costs hitting the bottom line (although these costs are probably not directly visible as they are rolled into various accounts). A number of recent examples include both foreign and Chinese companies having to make large provisions, or even restate financial statements, due to VAT-related errors or fraud.

The abundant risk/opportunity profile means it is critical for companies to clearly understand how China's VAT system works. While the risk profile may be higher than anticipated, companies also usually have opportunities to increase compliance, enhance cashflow efficiency and reduce costs. Once you know about the complexities of China's VAT regime, then it is clear that the "pass through" low-risk myth cannot be true. That is, there are high levels of risk and opportunities that should be explored.

Not surprisingly, the VAT costs and risks rise with the complexity of the legal entity type and the quantity of daily transactional processing. This is exacerbated in China since many companies have "mega-entities"

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that are part of an intricate global supply chain, and which process huge volumes of transactions. Each link in the supply chain may suffer VAT costs or "leakage" which results in a less efficient recovery of VAT. Unfortunately this is a common, but lesser known, occurrence in China. The following types of actual VAT costs incurred by a company operating in China that can impact the bottom line include:

- export VAT "leakage";
- VAT treated as non-creditable and required to be "transferred out";
- blocked VAT on certain non-creditable expenditures;
- VAT directly related to exempt business taxable services;
- deemed VAT sales amounts that are not passed onto customers;
- input VAT paid but the invoice not verified prior to expiration (e.g. 180 days);
- input VAT invoices without proper documentation;
- City Construction Tax (CCT) and Education Surcharge (ES) taxes that are assessed on VAT payable amounts;
- input VAT paid by a toll manufacturer;
- cashflow funding costs on pending refunds or extended periods of input credit delays.

Based on our experience, it may take significant efforts to identify, extract, collate and analyse a company's VAT data because this information resides in many different systems and parts of the organisation. Identifying this data is not an established practice at most companies yet, so it can be time consuming just to locate where the appropriate information resides. However, despite the difficulty, carrying out these tasks will benefit the company in the long run. Management is likely to be surprised about the size and magnitude of the unexplored VAT, but this reaction could spur a renewed interest in trying to manage this tax.

The following questions can help to assess your level of understanding about Chinese VAT:

- How much VAT throughput is being processed by the organisation on a monthly or annual basis?
- What is the VAT position of the organisation on a regular basis (e.g., input VAT carry forward, net VAT payable, pending export VAT refunds, etc.) and do these positions seem reasonable for the business profile?
- Are certain non-recoverable VAT costs incurred, either through non-VATable activities, export VAT "leakage", VAT transfer out, etc? Are these amounts known, managed and possibly reduced?
- How do company staff keep up-to-date with the rapid pace of regulatory change? Is anyone responsible for proactively reviewing new developments for impact to the company or does the company only respond reactively?
- How are VAT accounting transactions conducted in the system and by whom? Is the accounting system linked to the Golden Tax System (GTS)?
- Who is managing the VAT return preparation and reporting obligations? Are they able to accumulate the necessary data to accurately complete the returns on a timely basis? Where is the source data gathered from and how is it analysed prior to finding its way to a VAT return?

II. Changing VAT regulatory landscape

Recent years have seen large and small regulatory changes that need to be understood by companies who wish to be successful in China. For example, there have been over 500 updates to regulations from different agencies in each of the last few years, so it is not surprising that tax staff may miss an important VAT regulatory development that impacts the business.

The Chinese VAT pilot is a start to addressing the challenges stemming from the inefficiencies of China's indirect taxing system where services, intangibles and other items covered by the business tax (BT) regime do not interact with the items covered by the VAT regime. Many have asserted that these tax policies resulted in "double taxation", since BT and VAT are not creditable against each other. Unlike other countries with a merged GST regime, China has more cascading tax costs and blockage of VAT which otherwise would be creditable.

The VAT pilot transitioned three categories of business taxable items to the VAT regime and introduced two new rates along with a 0 percent rate for certain services.

It is designed to test the outcomes arising from the transition of certain BT services to VAT. The Shanghai VAT pilot was launched in January 2012 and has affected over 120,000 new "in-scope" VAT taxpayers.

Figure 2: VAT pilot in-scope services

General VAT taxpayers	Leasing	Movable property leasing	17 percent
	Transportation	Transportation services	11 percent
	Modern	R&D technology services	6 percent
		Information technology services	
		Culture and creative services	
		Logistics auxiliary services	
		Authentification and consulting services	
Small-scale taxpayers		All VAT pilot services	3 percent
Special		Other exempt or zero rates services stipulated by the MoF and SAT	0 percent

The VAT pilot also sets the scene for future VAT regulatory developments. The aforementioned in-scope VAT pilot services would be rolled out on a nationwide basis on August 1, 2013. Other services, such as financial services and real estate transactions will eventually be folded into the GST regime. Rapid expansion of the pilot to new locations may actually accelerate an overall reform due to the difficulties of administering different sets of rules that create cross-border transactions, even within China.

III. Managing VAT

Based on our experience, it is challenging to fully understand and appreciate how Chinese VAT affects a company. Especially since the governing regulations and VAT accounting treatment vary greatly from other internationally recognised systems. It is not difficult to see how keeping up with these developments could be a full time job for one or many staff.

Unfortunately, most companies do not have dedicated VAT resources with either the allocated responsibility or sufficient time to monitor, read and comprehend the frequently changing regulations. They are not able to develop insights into the implications for the company or how to respond appropriately.

VAT work in China requires more of everything: more transactions, more documentation, more paper, more invoices, more steps in the process, more data, more returns, more involvement of the CTB. This can overwhelm resources and lead to difficulty in maintaining compliance. In order to overcome the additional workload created by all the "more", it is important to understand how the major components of VAT link together in the organisation.

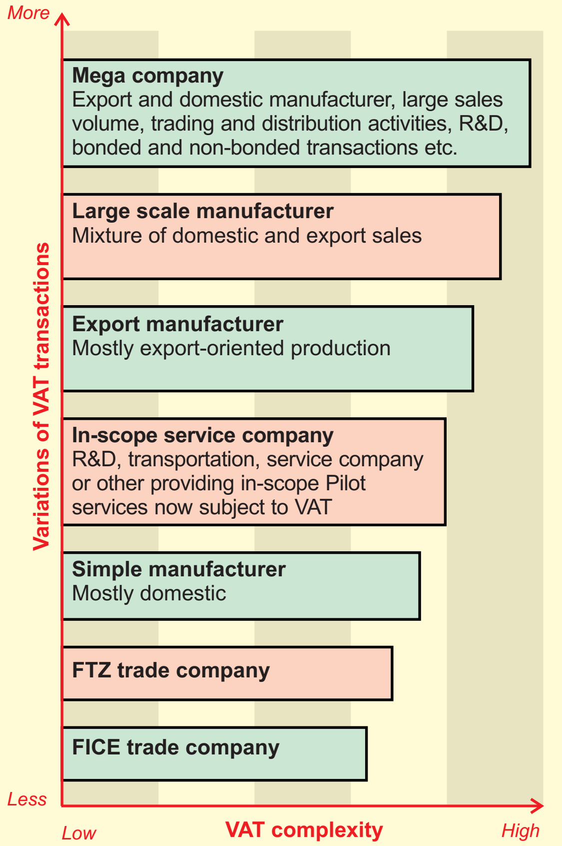
It is not surprising that once companies understand all of these important factors that they decide to dive deeper into Chinese VAT. How should they begin this journey?

China is almost unique in that most companies will have numerous legal entities performing different functions and this affects VAT in different ways. A starting point for assessing how to prioritise companies could be based on variations of the types of VAT transactions and VAT complexity of the type of legal entity and processes. It is important to note that this is not the only way to prioritise companies, nor does this equate to VAT risk — even a small legal entity with limited transactions can have high levels of risk. Even smaller companies can have more issues due to limited staffing levels, less understanding of the regulations and incomplete processes.

By diving into the depths of Chinese VAT, companies will benefit greatly through reduced risks, improved compliance, decreased costs and greater cashflow efficiency which can help both the top and bottom line.

Most companies can benefit greatly from focused projects that help to bring VAT operations to the surface, such as: VAT process reviews, discovery data analytics, reconciliations between ERP, VAT data; etc. Dedicated efforts at each legal entity will usually identify areas of strength, areas for improvement and potential savings opportunities that can set the agenda for future action to be taken by responsible VAT staff. Notwithstanding this, Figure 3 below seeks to provide a high-level idea of how types of legal entities may be plotted along the continuum of variations of transactions and overall complexity to assign a priority of where to start. By diving into the depths of Chinese VAT, companies will benefit greatly through reduced risks, improved compliance, decreased costs and greater cashflow efficiency which can help both the top and bottom line.

Figure 3: How to prioritise where to focus on China VAT?



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R&D tax incentives in Singapore

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In our second article in *Tax Planning International Asia-Pacific Focus*, canvassing the research and development (R&D) landscape across the Asia Pacific region, we turn our country-specific focus to Singapore. Herein, we describe the basic tenets of Singapore's R&D tax regime and also provide some insights and examples from our experience in delivering R&D tax services in the field. KPMG operates a global R&D Incentives practice deploying an integrated network of R&D specialists to advise multinationals and local businesses alike on obtaining R&D tax entitlements.

I. Introduction

Singapore is positioning itself as a science and innovation hub. Central among its strategies to achieve this aim is to raise public and private sector R&D spending.

In 2008, in an effort to encourage more private-sector spending on R&D, the Inland Revenue Authority of Singapore (IRAS) introduced a package of generous incentives, from financial grants to tax incentives, covering various activities along the productivity and innovation value chain.

The R&D tax incentive is intended to apply to all industries and is one component of Singapore's Productivity and Innovation Credit (PIC) scheme. The primary objective of this legislation has been to build R&D capability in Singapore by providing benefits to taxpayers that incur R&D expenditure and are the beneficiaries of the R&D activity.

II. R&D benefit categories

The PIC scheme provides a tax deduction of up to 400 percent on the first SGD$400,000 of qualifying R&D expenditure for each year of assessment from 2011 to 2015. The annual expenditure caps may be combined over multiple years as follows:

- Combined cap of SGD$800,000 for years of assessment 2011 and 2012.
- Combined cap of SGD$1,200,000 for years of assessment 2013 to 2015.

The three pillars of innovation under the PIC scheme are summarised below:

1. Enhanced tax deduction for R&D expenditure

All industry sectors are included in the target audience for the R&D tax incentive. Any business based in Singapore is eligible to lodge an R&D claim whether the R&D is undertaken in-house or outsourced, however, the claimant entity must be the beneficiary of the R&D activities.

Qualifying R&D, whether undertaken in Singapore or overseas, receives a tax deduction of 400 percent of actual expenditure on the first SGD$400,000 in each year of assessment (YA) and effective for the years of assessment 2011 to 2015.

For R&D conducted in Singapore, a tax deduction of 150 percent of actual expenditure applies to amounts above SGD$400,000. Moreover, taxpayers may be able to obtain a further benefit capped at a maximum of 200 percent of expenditure incurred instead of 150 percent. This additional benefit scheme requires application to and approval by the Singapore Economic Development Board.

If R&D is conducted overseas, a standard tax deduction of 100 percent applies to expenditure above SGD$400,000 per YA – that is, no enhanced deductions apply.

If the taxpayer chooses to outsource its R&D, 60 percent of the costs of that R&D are deemed as qualifying expenditure unless otherwise justified.

2. Enhanced tax deduction for registration of IP rights

All industry sectors are eligible to access this enhanced deduction of 400 percent on the first SGD$400,000 of expenditure incurred on patenting costs or other qualifying intellectual property (IP) registration costs in each YA between 2011 to 2015. Beyond SGD$400,000 of such costs a standard deduction of 100 percent applies.

The claimant entity must own the legal and economic rights to the IP for a minimum period of one year from the date of filing to the date of disposal. If this requirement is not met, clawback provisions will apply.

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3. Enhanced writing-down allowance for acquisition and licensing in of IP rights

As for 2 overleaf, all industry sectors comprise the target audience for the enhanced IP write-down provision which allows for a 400 percent claim on the first SGD$400,000 of expenditure incurred in acquiring IP rights. This benefit applies for each YA between 2011 to 2015.

The claimant entity must own the IP rights for at least five years from the date of acquisition to the date of disposal, failing which clawback provisions will be applied.

Additionally, effective from the YA 2013, licensing rights have been included in addition to the current benefits for IP acquisition under the PIC scheme. This is in response to an evolving innovation ecosystem where companies may prefer to pay licence fees for the use of certain IP rights (e.g. technology) instead of always acquiring the IP. With the current enhancement made to the PIC scheme, businesses that make licence/royalty payments, excluding franchising arrangements, from YA 2013 to YA 2015 would qualify for the PIC benefits.

III. Qualifying as R&D

The Singapore Government requires that R&D activities must be conducted either by the taxpayer directly or contracted by the taxpayer to an R&D organisation within Singapore. In both of these scenarios, R&D tax concessions will only apply to R&D expenditure incurred by a taxpayer that remains the beneficiary of the R&D activity.

R&D activities may be performed overseas, however, the activities must relate to the R&D claimant's existing trade or business.

Importantly, the Government recognises that R&D occurs not only in the obvious areas of manufacturing and engineering, but also increasingly within the services sector of the Singapore economy.

IV. The definition of R&D

IRAS's definition of R&D activity is largely aligned with neighbouring jurisdictions which does simplify the R&D tax claim process for multinationals. For the purposes of determining tax concessions, Singapore defines R&D as:

> "any systematic, investigative and experimental study that involves novelty or technical risk carried out in the field of science or technology with the object of acquiring new knowledge or using the results of the study for the production or improvement of materials, devices, products, produce, or processes. . ."

The definition continues to exclude certain activities which are further explained in the section below: *What does not constitute R&D*.

For the purposes of practical application, the above definition can be broken down into three points to consider as follows:

1. What type of activity was undertaken?

The taxpayer must be able to demonstrate that its R&D efforts were not comprised of random, uncoordinated or unstructured activities but rather that its R&D was undertaken in a systematic, investigative and experimental way within science or technology disciplines.

The taxpayer should use suitably qualified personnel to conduct the R&D and retain the data and/or results from the R&D as well as any reports detailing success or failures.

2. Why was the activity performed?

The fundamental reasons for conducting R&D should be to acquire new knowledge or to create new or improve existing products or processes. This means that the taxpayer is looking to test something that is not known or not readily deducible without performing the R&D activity.

Most importantly, success of R&D activities is not a pre-requisite for eligibility of the R&D tax concession as failure is often a good indicator of technical risk.

3. What was involved in the R&D activity?

To achieve the objectives stated in the preceding point, an R&D project must seek out a novel solution or involve technical risk.

Novelty typically refers to something that is new in relation to the creation or improvement of products or processes or the development of knowledge. For example, a company may satisfy the test for novelty if it modified existing technology or processes from one industry for use in another industry where such use of the technology was not previously deployed.

Technical risk is usually encountered during an R&D project when the taxpayer needs to address scientific or technical issues that cannot be readily resolved by a competent professional in the relevant technical field. Undertaking R&D in this context, the taxpayer faces technical risk. Examples include the use of new materials to improve or add functionality, using new materials to create new products that behave differently in a production environment, the production of smaller or lighter products as well as the integration of technologies not previously attempted.

V. What does not constitute R&D?

By placing emphasis on aspects of novelty, technical risk, new knowledge, systematic, investigative and experimental activities in science and technology fields, the Singapore Government thereby excludes certain activities from being considered as R&D. Excluded activities are quality control testing, other routine testing, routine data collection, cosmetic modifications or stylistic changes, market research, sales promotion activities, efficiency surveys or management studies.

IRAS excludes these types of activities from R&D tax incentives for several reasons:

- To focus more clearly R&D on the fields of science and technology.
- To clearly delineate R&D from routine activities or improvements that occur during the ordinary course of the taxpayer's business.
- To separate R&D activities from work that occurs before and after the R&D stage.

VI. Software R&D

In July 2012, IRAS amended the R&D tax legislation and removed the previous exclusions that related to software development. The changes suggest that IRAS recognises software innovation and development as equally important to R&D undertaken in other areas of science and technology.

Specifically, for YA 2012 onwards, IRAS decided to remove the existing "multiple sale requirement" which previously excluded software that was developed without the intention for sale, rent, lease, license or hire to two or more unrelated parties, therefore disadvantaging companies that developed innovative software platforms that were for internal purposes only.

The IRAS amendments acknowledge the importance of software R&D whether for external sale or internally focused on ERP, CRM or accounting systems.

However, IRAS has also released examples of the types of software development that would not be regarded as R&D. These relate to routine software development, specifically the use or implementation of capabilities of existing software as it was intended to be used and within existing limitations.

Overall, the changes provide a welcome opportunity for all businesses to reassess any aspect of their R&D activity that may involve software development and to, therefore, convert significant IT investment into tax savings. This is especially true for service sector businesses which thrive on the quality of their customer service. In our increasingly digital, real-time and mobile world, the delivery of services requires continuous reinvention and transformation to meet and exceed customer demands.

VII. Claiming the R&D incentive

Businesses are required to lodge their enhanced R&D tax deduction claims in their annual tax return. Detailed technical project descriptions are required when aggregated R&D expenditure equals or exceeds SGD$150,000, net of any government subsidies including grants.

R&D tax claims are subject to detailed review by IRAS as part of their standard tax assessment protocols.

VIII. Examples and insights from R&D in Singapore

In accordance with the definition of R&D above, businesses from all industries can now claim the R&D incentive.

Examples of potentially qualifying projects are as follows:

(i) The development of a new or significantly improved product

A food development company attempts to create a new or significantly improved formulation to achieve higher food quality (e.g. better texture and taste) that is not available by competitors in the market. The development of formulations would potentially have technical risk if a competent professional would not know how to achieve the desired result at the outset of the project.

For example, in the development of food formulations, technical risk may be present in achieving the correct balance of elements to achieve the desired quality, or in undertaking development to increase product quality while ensuring the product remains cost effective. Hence, the company is required to conduct systematic, experimental and investigative processes to arrive at the ideal food formulation that may meet the requirements of the definition of R&D in Singapore.

(ii) The development of a new and advanced core IT system in the financial sector

A commercial banking company attempts to design and develop an advanced core banking system with extensive functionality (e.g. new products and services) to be used by their clients. Due to the company's highly complex and disparate IT infrastructure, the development may have significant technical risks.

For example, in the development of the core banking system, technical risk may be present in achieving a system with extensive new functionalities while ensuring the system is highly secured and able to operate in a variety of environments and meet stringent legislative requirements. Ensuring communication between multiple disparate technologies that have not communicated previously, and where there is no such standard, as well as the integration of multiple disparate internal technologies may create technological risk. Hence, the company may be required perform several iterations of design, development and testing to ensure the advanced core banking system could meet its overall technical requirement.

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New Zealand: Budget 2013 and recent tax changes

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I. Introduction

The New Zealand Budget for 2013–14 was delivered on May 16. In contrast to the Australian Budget the week before, a combination of successful expenditure control and revenues ahead of previous forecasts allowed the Government to maintain its 2012 Budget forecast of returning to surplus in 2014–15, although the size of the surplus predicted has been trimmed since last year's Budget to a barely measurable NZ$79 million.

The surplus has been achieved without any increase in general tax rates, other than an increase of 3 cents per annum for the next three years in the petrol excise tax (currently NZ$0.50 per litre, low by international standards, and justified at least in part by a decline in the volume of petrol sold).

On May 20, the Government introduced the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill. This Bill is primarily concerned with overhauling the taxation of non-hydrocarbon mining (primarily gold, silver and iron sands), and proposing a new and simplified regime for the taxation of immigrants with non-New Zealand workplace savings.

II. Tax changes announced in the Budget

Reflecting the relatively favourable state of affairs in the public finances, Budget 2013 includes only three modest tax changes, two of which are taxpayer favourable.

A. Deductions for "black hole expenditure"

The first proposal favourable for taxpayers is to allow a deduction for certain items of expenditure for which no deduction or capitalisation is currently allowed or available. These are the costs of:

- failed patent or plant variety right applications;
- failed applications for limited life resource consents;
- some company administration matters, e.g. annual general meetings, or paying a dividend.

This change is proposed to come into force in the 2014–15 tax year.

B. R&D tax credit

The second proposal is to introduce a cash refund of losses arising from R&D expenditure incurred by start-up businesses. This proposal is yet to be developed, and seems unlikely to come into force before the 2015–16 tax year. However, it is likely to gain impetus from a recent report showing New Zealand expenditure on R&D is only 1.2 percent of GDP, compared to an OECD average of 2.44 percent.

C. Expanding the thin capitalisation regime

The Budget confirmed the Government's intention to expand the current thin capitalisation regime. The regime will apply not only to New Zealand companies with a single foreign controller, but also to companies which are controlled by a group of non-residents. Legislation to achieve this is proposed to be introduced in August, to take effect in the 2014–15 tax year.

This measure is potentially the most far-reaching and complex of those in the Budget. New Zealand has a relatively pure thin capitalisation regime, which denies a deduction for both related and third party interest incurred by an New Zealand corporate group which is:

- controlled by a single foreigner; and
- has a debt-to-asset ratio which exceeds the greater of:
  - 60 percent; or
  - its worldwide debt to assets ratio.

If the regime applies, the company is effectively disallowed a deduction for the portion of its interest bill which reflects the percentage by which its debt is above the permissible maximum.

There is a separate regime for foreign controlled banks, based on a requirement for capital equal to 6 percent of risk weighed exposures.

The requirement for a single foreign controller excludes from the regime both:

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- majority foreign owned but widely held companies like Telecom; and
- companies with a tighter majority foreign shareholding, such as often occur in forestry, or in companies controlled by a group of private equity funds.

The Government wants to bring this second group within the thin capitalisation regime. The particular "mischief" it has identified is the possibility that the shareholders will fund the company primarily with shareholder loans. With no thin capitalisation rules applying, interest on such loans is fully deductible, while the shareholders are generally subject to nonresident withholding tax on the interest at a rate of 10 percent gross. This is a lower rate than the effective 28 percent imposed on profits distributed on equity.

The main legislative features of the proposal will be:

- a definition of when shareholders are acting together in a way that brings the company within the regime. This definition has yet to be developed. It is likely that it would include shareholders who are party to a shareholders' agreement, covering such actions as voting and selling their shares. It is not clear how much further it might go; and
- an exclusion of shareholder debt when measuring the worldwide debt-to-assets ratio.

III. Changes included in the Bill

A. Minerals mining

New Zealand's current regime for the taxation of non-hydrocarbon mining contains numerous concessions. Most expenditure, whether it is on prospecting, exploration or development, is deductible either when incurred, or up to two years before that time (subject to certain requirements). The Bill proposes to continue with a special purpose regime for such mining, but to bring it closer into line with general tax principles. However, important differences remain. The main elements of the regime as introduced in the Bill are:

- Prospecting and exploration expenditure immediately deductible, though non-permit specific assets will have to be depreciated.
- No deduction for expenditure on acquiring land for mining purposes until the land is sold.
- Deductions for successful exploration expenditure recaptured, if incurred on items subsequently used to operate a mine.
- Mine development expenditure to be spread over the life of a mine, either on a unit of production basis (for items whose life is tied to that of the mine) or under the depreciation rules.
- Ordinary capital/revenue rules to determine the deductibility of costs incurred in operating a mine – (for example, costs incurred in acquiring a non-permit-specific depreciable asset would be deductible under the ordinary depreciation rules).
- Repeal of the special rules allowing a corporate shareholder in a mining company a deduction for losses on loans made to the company, if the loans are used to fund mining activities.
- Reclamation/restoration expenditure to be deductible only when paid. This prevents an argument that such expenditure is "incurred" (and therefore deductible, under the usual test) as the obligation to pay it accrues by virtue of mining operations. Although this seems an extraordinary and unwarranted departure from general principles, no explanation is given for it. The Bill does propose that a potentially complex refundable credit be allowed for such expenditure, to deal with the fact that it may be incurred after income has ceased to be earned.
- The current treatment of mining tax losses to continue. Generally this involves the ring-fencing of losses to permit areas, and the ability to carry them forward without regard to shareholder continuity.

The proposed extension has required some other modifications to the regime for the newly included groups. They will not be subject to interest disallowance if they have no shareholder debt. If they do have shareholder debt, then they will be subject to interest disallowance if:

- their total debt to assets ratio exceeds the 60 percent threshold; and
- their shareholder debt exceeds 10 percent of their third party debt.

These changes are intended to apply from the beginning of the 2014–15 tax year. Submissions will be called for by the Select Committee considering the Bill.

B. Foreign superannuation

The tax treatment of interests in foreign superannuation schemes and other forms of retirement savings held by migrants to New Zealand has for years been both complex and unfair. While the four year transitional resident rule solved the issue for temporary migrants, for those remaining in New Zealand for a longer period, tax outcomes were sometimes arbitrarily harsh, and non-compliance was correspondingly high (the Government estimated a 70 percent non-compliance rate). Taxpayers were often particularly bemused by the application of the foreign investment fund (FIF) regime, which imposed New Zealand tax on either purely fictional, or unrealised, gains. These are the same rules that apply to the taxation of most foreign portfolio equity investments made by New Zealand residents.

The Bill proposes a special regime for taxing foreign superannuation interests held by New Zealand residents, with effect from the 2014–15 tax year. The regime has the following key elements:

- Immigrants will generally be able to move their foreign superannuation into a New Zealand vehicle subject to New Zealand tax with no New Zealand tax on the transfer, if they do so within four years of becoming New Zealand residents. This ability can be used only once. Whether this is possible or advisable will of course also depend on the tax and non-tax rules applying in the relevant foreign jurisdiction. One relevant fact may be that New Zealand savings vehicles are generally fully taxable, their only tax benefits being the maximum 28 percent tax rate and the exemption from tax on gains on Australian listed and New Zealand equities.
- After the four-year period, any payment out of a foreign superannuation scheme to either the immigrant, or an Australian or New Zealand scheme for

their benefit, will be taxable to the immigrant, under either the schedule method or the formula method. Amounts received on transfer of an interest will be taxed in the same way.

- The schedule method treats a portion of the payment as income, regardless of whether that payment has come from contributions to or earnings of the scheme. The portion increases over time, from 4.76 percent in year 1 to 100 percent in year 26.
- The formula method attempts to tax only:
  - the portion of the payment which is attributable to the growth in value of the superannuation investment which occurs after the person has been New Zealand tax resident for four years; plus
  - an additional amount to recognise the value of deferral (i.e. tax only on payment, rather than accrual).
- Transfers from one non-Australasian scheme to another are not taxable.
- The proposed regime does not apply to:
  - foreign pensions, annuities or social security receipts. As is currently the case, these payments are fully taxable on receipt, subject to potential application of a tax treaty;
  - payments from Australian superannuation schemes, which are specifically exempt under the NZ/Australia tax treaty.

The Bill proposes to amend the provisions relating to the statutory superannuation scheme, known as KiwiSaver, to allow early withdrawals to pay any tax imposed on payments under the above regime.

The Bill also contains transitional provisions.

Anyone who previously declared income from their foreign superannuation scheme under the FIF regime may continue to do so.

Anyone who did not declare income from their foreign superannuation scheme under the FIF regime and who has received, or receives before April 1, 2014, a lump sum payment, can treat only 15 percent of that payment as taxable.

These changes are likely to be of reasonably widespread interest, given the high number of New Zealand expatriates who eventually return to New Zealand. Again, submissions will be called for.

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Australia's first responses to base erosion and profit shifting

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I. The politics

The Australian Government has identified that globalisation and the rise of the digital economy is jeopardising its corporate tax base. The problem of globalisation is not new, but its significance continues to increase as Australian consumers of e-commerce products contract directly with offshore entities. Multinationals such as Google, eBay and Apple have been caught in the political debate.

Treasurer Wayne Swan said in a media release on May 14, 2013 that: "Protecting the integrity of our corporate tax system will ensure a stable source of revenue to fund vital investments in our economy and community, underpinning a stronger, smarter and fairer Australia."[1]

This rhetoric is significantly more moderate than previous statements to the *Australian Financial Review* made by the Assistant Treasurer that: "[M]ultinationals that failed to pay their fair share of tax were 'free riding on the efforts of others'."[2]

In May 2013, the Australian Government's Treasury Department released a paper titled *Implications of the Modern Global Economy for the Taxation of Multinational Enterprises*, which highlighted the challenges faced in an ever-changing global economy and with the current international tax system. The paper stated that: "These developments in the global economy over recent decades pose a number of challenges to the ability of the international tax system to deliver appropriate outcomes for countries. *A key issue is whether tax concepts developed for the industrial age can be made to work in the era of the digital economy*."[3] (author's emphasis in italics)

The Treasury's paper drew much of its substance from the Organisation for Economic Co-operation and Development (OECD) report titled *Addressing Base Erosion and Profit Shifting*. The OECD report commented on the importance of reform:

> "What is at stake is the integrity of the corporate income tax. A lack of response would further undermine competition, as some businesses, such as those which operate cross-border and have access to sophisticated tax expertise, may profit from [base erosion and profit shifting] opportunities and therefore have unintended competitive advantages compared with enterprises that operate mostly at domestic level."[4]

Unfortunately, the Australian Government's preliminary response was to patch up some of the existing provisions and rule out a comprehensive review that would necessarily include a review of taxing consumption expenditure in Australia.

II. Inherent nature of base erosion

The serious tax challenge for Governments is the trend of multinationals moving from replicating their business model in multiple jurisdictions to operating an integrated global structure with favourable tax consequences in a single economic environment. An example of this is the use of a structure such as the 'Double Irish Dutch Sandwich', which has received substantial political airtime in Australia. The increasing importance, value of and mobility of intellectual property means that economic assets do not need to be located near either production centres or sales markets. The OECD summarised the issue:

> "Globalisation is not new, but the pace of integration of national economies and markets has increased substantially in recent years. *The free movement of capital and labour, the shift of manufacturing bases from high-cost to low-cost locations, the gradual removal of trade barriers, technological and telecommunication developments, and the ever-increasing importance of managing risks and of developing, protecting and exploiting intellectual property have had an important impact on the way multinationals are structured and managed*. This has resulted in a shift from country-specific operating models to global models based on matrix management organisations and integrated supply chains that

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> centralise several functions at a regional or global level. Moreover, *the growing importance of the service component of the economy, and of digital products that often can be delivered over the internet, has made it possible for businesses to locate many productive activities in geographic locations that are distant from the physical location of their customers*."[5] (author's emphasis in italics)

The rise of the digital economy is a key example of how the current international tax rules fall short of what is considered equitable tax. The OECD observed that: "[C]urrent international tax standards may not have kept pace with changes in global business practices, in particular in the area of intangibles and the development of the digital economy."[6]

Consequently the adequateness and sustainability of taxing multinationals poses a challenge as it has become apparent that it is now "possible to be heavily involved in the economic life of another country. . .without having a taxable presence therein."[7]

The heart of the base erosion problem in Australia is that income tax is levied on source and residency. In the digital era, economic activity in the form of sales to Australian consumers will remain untaxed as long as multinationals have no residence or permanent establishment in Australia. There are many commercial reasons why multinationals would not want to establish a resident subsidiary or permanent establishment in Australia.

There are local laws requiring compliance with corporations, employment, immigration, consumer and competition, contract and intellectual property rules (to name a few). Simply in terms of compliance costs, in many cases it is attractive for multinationals to minimise their overseas presence, especially if this is multiplied across various jurisdictions, regardless of the tax implications.

The solution requires a fundamental rethink of how to tax either consumption expenditure or e-commerce transactions connected with Australia. In Australia, consumption expenditure is currently taxed by the GST, but its base does not extend to adequately taxing consumption of digital products from overseas suppliers. There is also heavy political reluctance to discuss any amendments to the base and rate of the GST.

III. Proposals paper

In May 2013, the Australian Government released a paper titled *Addressing profit shifting through the artificial loading of debt in Australia*. The proposal paper seeks to: "address profit shifting opportunities that arise when multinational entities (multinationals) have the ability to artificially load excessive amounts of debt in their Australian operations."[8]

There are three limbs to the proposed reforms:[9]

1. Tightening the safe harbour settings in the thin capitalisation rules while still ensuring taxpayers have access to other tests where they have higher borrowings at commercially independent levels.
2. Implementing the 2009–10 Budget announcement to reform the exemption for foreign non-portfolio dividends (section 23AJ of the *Income Assessment Act 1936*).
3. Repealing the special rule that allows tax deductibility for interest expenses incurred in deriving exempt foreign income (section 25–90 of the *Income Assessment Act 1997*).

The above reforms are proposed to have effect for income years that commence on or after July 1, 2014. This is to provide time for taxpayers to rearrange their financing arrangements.

A. Shrinking the size of the thin capitalisation safe harbours

The safe harbours in the thin capitalisation rules provide certainty to taxpayers. To the extent that Australian debt deductions are within the safe harbour, those deductions are generally allowable (subject to the general deductibility principles and specific rules such as the transfer pricing provisions). Currently, there is a general safe harbour for a debt-to-equity ratio of 3:1.

> "The serious tax challenge ... is the trend of multinationals moving from replicating their business model in multiple jurisdictions to operating an integrated global structure..."

The Treasury is concerned that the existing rules are too concessional and have proved "ineffective in achieving their stated policy objective of ensuring that debt is not artificially loaded in the Australian operations". The paper states:

> "The Reserve Bank of Australia's Financial Stability Review of March 2013 [which] indicates that business gearing levels have remained at relatively low levels. Among listed non-financial corporates, the aggregate gearing (book value debt-to-equity) ratio was estimated to be 54 percent as at December 2012. According to the Treasury's analysis of the 2011 financial statements for 2044 ASX listed companies (other than banks) 95 percent of those companies had gearing levels less than 1.5:1."[10]

Treasury considers that this means "taxpayers can load debt into Australia using the difference between debt levels that would be adopted for non-tax reasons and the safe harbour limit".[11] The proposed reforms alter the safe harbour debt to equity ratio from 3:1 to 1.5:1 – or from 75 percent to 60 percent on a debt-to-total assets basis.

In addition, there is a proposal to amend the worldwide gearing test. The paper states:

> "The worldwide gearing test permits gearing to the level of the worldwide group of which the entity is a

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> member. The test currently allows gearing in Australia to be equal to 120 percent of the group's global gearing. This will be reduced to 100 percent so that deductible expenses for gearing in Australia is proportionate to the global gearing of the group. A ratio of 100 percent directly addresses the issue of debt being artificially loaded in Australia that the rules are designed to address."[12]

Currently, the worldwide gearing test is only available to outbound investors. However, in the proposed reform this will be extended to inbound investors on the basis that:[13]

> "This test better reflects the policy intent of the thin capitalisation rules to prevent the excessive allocation of debt to Australia for tax purposes. It allows the Australian operations to claim deductions on their debt where they are geared to the same level as the global group."

The legislation will continue to include an arm's length test. This is generally used by taxpayers with worldwide gearing levels above the relevant safe harbours, but with borrowings that are consistent with arm's length arrangements.

In summary, the proposed thin capitalisation reforms are as follows:

- The safe harbour debt limit for 'general' entities will be reduced from 3:1 to 1.5:1 on a debt to equity basis. This translates to a reduction in the safe harbour from 75 percent to 60 percent on a debt-to-total asset basis.
- For non-bank financial entities, the safe harbour debt limit will be reduced from 20:1 to 15:1 on a debt-to-equity basis (or 95.24 percent to 93.75 percent on a debt-to-total asset basis).
- For banks, the safe harbour capital limit will be increased from 4 percent to 6 percent of the risk weighted assets of their Australian operations.
- For outbound investors, the worldwide gearing ratio will be reduced from 120 percent to 100 percent (with an equivalent change to the worldwide capital ratio for banks).

The reforms also aim to reduce compliance costs and ensure small businesses are excluded from the regime. The current *de minimis* threshold is proposed to be increased from AUS$250,000 to AUS$2,000,000 in debt deductions.

B. Non-portfolio dividend exemption

There is currently an arbitrage opportunity in the income tax provisions where an Australian entity lends to a related overseas entity.

The opportunity involves structuring the transaction so that the interest received by the Australian entity is characterised as an exempt non-portfolio dividend.[14]

The proposed reform is that such transactions are characterised based on their substance rather than legal form, with the effect that the Australian entity is liable for interest received from the related overseas entity.

C. Deductibility of interest for foreign exempt income

The current income tax rules contain specific provisions allowing certain deductions in relation to foreign exempt income.

This provision is to be repealed under the proposed reforms.

IV. A meaningful review

The current proposed reforms are not intended to be comprehensive. However, the greater concern is the current Australian Government's reluctance to commit to a meaningful review of the overarching structure for how international transactions must be taxed.

The OECD in their report recommended that:

> "[A] holistic approach is necessary to properly address the issue of [base erosion and profit shifting]. Government actions should be comprehensive and deal with all the different aspects of the issue. These include, for example, the balance between source and residence taxation, the tax treatment of intragroup financial transactions, the implementation of anti-abuse provisions, including CFC legislations, as well as transfer pricing rules. A comprehensive approach, globally supported, should draw on an in-depth analysis of the interaction of all these pressure points. It is clear that co-ordination will be key in the implementation of any solution, although countries may not all use the same instruments to address the issue of [base erosion and profit shifting]."[15]

In the Australian context, there needs to be a fundamental shift in how the problem is dealt with at the political level. Taxes on consumption expenditure (such as GST) or taxes on e-commerce transactions (such as those proposed in France) must be central considerations in solving the base erosion issue. Discussing these options must, at the very least, be considered as part of a broader review. Plugging holes by amending thin capitalisation safe harbours and amending isolated provisions on exempt income and deductibility will not protect the revenue base in any meaningful way.

Former NSW premier Nick Greiner stated that a review of the GST was imperative "due to the perilous public finance conditions facing state governments."[16] The unfortunate response from the Assistant Treasurer was to issue a press release stating that:

> "The Liberals introduced the GST and now the Liberal Premiers are pushing Mr Abbott to increase the tax . . . A change to the GST would jack up the prices for consumers and rip away services from smaller states like Tasmania and South Australia."[17]

Until there is acknowledgement that structural reform is required, and that amendments to the scope of the GST and other transactional tax solutions must be considered, the base erosion problem will continue to worsen regardless of the number of patches that are applied in the meantime.

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Vietnam's taxes on business

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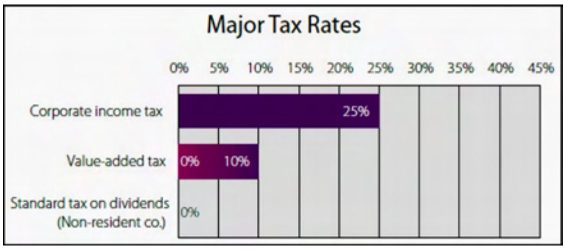
Given the weak global economic outlook and its internal economic issues, the Government in Vietnam is likely to extend a number of beneficial measures to help companies to overcome short-term difficulties.

In a tough global economy, major foreign investors in certain industrial sectors continue to prioritise their investments into Vietnam as a strategy to diversify sourcing options and supplier portfolios outside of China. Many first and second tier suppliers, including small to medium-size enterprises, are following in their footsteps, acting on the business potential that Vietnam holds for companies involved in a larger supply chain providing goods and services to manufacturing hubs in Asia.

It is therefore increasingly important to understand the taxes which Vietnam imposes on business, such as business licence tax, corporate income tax and value added tax.

All taxes in Vietnam are imposed at the national level, as there are no local, state or provincial taxes (although the implementation of these could have different interpretations according to different officials in different cities).



I. Business licence tax

Business licence tax (BLT) is an indirect tax imposed on entities conducting business activities in Vietnam, paid by enterprises annually for each calendar year that they do business in Vietnam. All companies, organisations or individuals (including branches, shops and factories) and foreign investors operating businesses in Vietnam are subject to BLT.

The amount of BLT due is based on the amount of charter capital, as shown in the accompanying table. For state-owned enterprises, limited liability companies and joint stock companies, the registered capital is the charter capital.

Business Licence Tax (BLT) Rates for Economic Entities	
Registered capital (billion VND)	**BLT/year(VND)**
Over 10	3,000,000
From 5 to 10	2,000,000
From 2 to under 5	1,500,000
Under 2	1,000,000

II. Corporate income tax

The Corporate Income Tax Law was approved by the National Assembly in 2008 and came into effect in 2009. Corporate Income Tax (CIT) is a direct tax levied on the profits earned by companies or organisations. All income arising inside Vietnam is subject to CIT, no matter whether a foreign enterprise has a Vietnam-based subsidiary or whether that subsidiary is considered a permanent establishment. The standard CIT rate is 25 percent for both domestic and foreign-invested enterprises (FIEs) in most industries.

In an effort to attract more foreign direct investments, boost investment in Vietnamese businesses and to support struggling local enterprises, Vietnamese lawmakers have recently approved the Government's proposal to reduce the current CIT rate from 25 percent to 23 percent (the new rates are expected to take effect starting January 1, 2014).

This new tax rate would put Vietnam at an advantage over other neighbouring countries such as China (25 percent) Indonesia (25 percent) and the new rising star Myanmar (30 percent). Having said that, other countries such as Thailand do offer a lower CIT rate at 20 percent and also more attractive incentives and tax breaks for newcomers.

Now that macro-economic problems such as inflation, currency movements and high interest rates seem to have been brought under control, Vietnam needs to step up efforts to invert the trend of declining foreign direct investment (FDI) in recent years. Over the last decade, Vietnam has cancelled many of the tax breaks and incentives it used to grant to investors. At the moment, only high tech, R&D, green technologies,

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selected services and software manufacturing sectors, including investments in economic zones and low socio-economic areas, attract CIT exemptions and deductions.

When calculating CIT, FIEs can deduct most expenses paid for production and business activities if supported by adequate lawful invoices and documents. This is another area of concern for FIEs in Vietnam, as frequently many expenses are barred from being deducted given the fact that they are not supported by official invoices, or that they exceed some pre-determined caps (for example, on advertising, marketing and promotional expenses). This effectively means that in many cases the tax rate of a company will be higher than 25 percent.

III. Value added tax

Value added tax (VAT) is imposed on the supply of goods and services at three different rates: 0 percent, 5 percent and 10 percent (the standard rate).

Goods and services encouraged by the Government are exempt from VAT. These include agricultural products, healthcare services and scientific activities, derivative financial and credit services, securities trading, insurance services, education and vocational training, printing and publishing newspapers.

All organisations and individuals producing and trading goods and services in Vietnam are liable to pay VAT, regardless of whether the organisation has a Vietnam-based establishment.

There are two different methods of calculating VAT: the credit method (also called the "deduction method") and the direct method. Most businesses are required to use the credit method which applies to FIEs, foreign parties to business co-operation contracts, and business organisations fully implementing the accounting regime stipulated by law in Vietnam. The direct method is applicable to companies, organisations and individuals without a resident establishment in the country.

VAT Rates	
Rate	**Applicability**
0%	Goods and services for export or sold to non-tariff zones
5%	15 categories ▪ Fertilisers ▪ Medical equipment and instruments ▪ Scientific and technological services ▪ Cultural, exhibition, physical training and sports activities
10%	Everything else

A. Credit method (deduction method)

Payable VAT amount = output VAT amount – creditable input VAT amount

Under the credit method, payment and declaration of VAT is made on a monthly basis, where the taxpayer subtracts the input VAT from the output VAT, and pays or claims the balance to the relevant bodies. As mentioned above, the direct method applies to business establishments and foreign organisations or individuals without resident offices and which have not implemented the Vietnamese Accounting System, but generate income in Vietnam, along with those in specific industries (such as gold, silver and gem trading activities).

B. Direct Method

Payable VAT amount = added value of sold goods or services X VAT rate

Added value of sold goods or services = selling price – purchasing price of said goods or services

According to this method, VAT depends on total revenues. As such, the monthly payments are just provisional and the total amount of VAT may be different at the end of the year. Therefore, when using the direct method of calculation, tax finalisation procedures must be completed within three months following the end of the year.

For goods and services purchased from abroad, VAT applies to the duty paid value (the sum of the value and the duty paid) of imported goods and services. The importer must pay VAT at the same time that they pay import duties to customs.

> "Given the still weak global economic outlook and the internal economic issues... it is likely that the Vietnamese Government will continue to extend a number of beneficial measures..."

IV. Conclusion

Given the still weak global economic outlook and the internal economic issues which are still hampering the development of local and foreign enterprises in Vietnam, it is likely that the Vietnamese Government will continue to extend a number of beneficial measures to help companies to overcome short-term difficulties. These should include the extensions of deadlines for CIT and VAT payments of eligible enterprises.

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At the same time, foreign companies in Vietnam are likely to face harsher fines for missing tax deadlines and for not being compliant to the various laws and regulations. Transfer pricing audits will also increase in number and depth, given the fact that exports count for a whopping 70 percent of gross domestic product and that the majority of the sector is foreign invested.

The Vietnamese Government will have to play a fragile balancing act. On one hand it has to ensure that its fiscal grip is not too tight to choke the still delicate economy, disrupt the investment environment, and unnecessarily divert FDI to other neighboring countries in search for the ideal manufacturing hub in Asia. On the other hand, it needs to ensure that fiscal compliance is implemented efficiently and revenues continuously flow into the tax bureau's coffers in order to mitigate the inefficiencies of state-owned enterprises and their inability to pay back state bank loans and Government accumulated debts.

With the ASEAN free trade agreements coming into full play by 2015 and the much anticipated additional trade pacts, Vietnam is scheduled to sign with both the European Union and the United States. The country has much to lose if the Government does not continue along the hard but necessary road to economic development and financial stability.

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"Secondment" or "service" – the SAT of China gives its answer

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I. Introduction

In the last few years, many multinational groups have been facing increasing scrutiny from the Chinese tax authorities on their secondment arrangements in China. This is because secondment arrangements were often suspected to be established to cover up the services provided by the foreign Home Entity[1] to the Host Entity[2] in China. This has resulted in widespread tax disputes. In some cases, the Home Entities were required to pay tax to China to settle the disputes. Some had to incur extra time and costs to defend their cases many of them remain unresolved to date.

The State Administration of Taxation (SAT) recently released a long-awaited tax circular Public Notice [2013] No.19 (Public Notice 19). It provides both technical and practical guidelines for the assessment of the nature of secondment arrangements. Hopefully, it will help to resolve outstanding disputes and set out a clear framework for reference of Home Entities, Host Entities, and the Chinese tax authorities.

II. Issues in secondment arrangements

Under most secondment arrangements, the Home Entity would settle the salary and benefits to the secondees at the home country and seek to recover these costs from the Host Entity in China. The most contentious issue is whether such payment is merely for cost reimbursement or in the nature of fees for services provided by the Home Entity to the Host Entity via the secondees. No Chinese corporate tax consequences would arise if it is merely a cost reimbursement. If the payment is considered as fees for services, the Home Entity may be taken as having created an establishment and place (E&P)[3] or permanent establishment (PE)[4] in China and subject to Chinese Corporate Income Tax (CIT).

Although an existing SAT circular[5] has already laid down the principles for assessing the nature of secondment arrangement, both the local-level tax authorities and multinational groups have been facing difficulties in dealing with the issue (which mostly ended up with disputes) in the absence of practical guidelines. Public Notice 19 now introduces practical guidelines on the specific factors that need to be considered and the detailed documentation requirement.

III. Overriding principle

According to Public Notice 19, the Home Entity shall be taken as having created an E&P/PE for the provision of services in China if the Home Entity:

- fully or partially bears the responsibilities and risks of the secondees' work; and
- normally evaluates and assesses the secondees' performance.

The SAT mainly looks at which party is the economic employer of the secondees in determining whether service has been provided by the Home Entity to the Host Entity. This is the overriding principle in assessing the nature of the secondment arrangement and is generally in line with international tax practice.

IV. Five supplementary factors

Public Notice 19 also sets out the following five supplementary factors which have to be considered in applying the overriding principle:

1. Whether the Host Entity pays management fees or service fees to the Home Entity for the secondee;
2. Whether the Host Entity over-reimburses the Home Entity for the salaries, social security and other expenses of the secondees;

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3. Whether the Home Entity does not pay the full amount received from the Host Entity to the secondees and retains a certain amount;
4. Whether Chinese Individual Income Tax (IIT) has not been fully paid on the income of the secondees that is borne by the Home Entity;
5. Whether the Home Entity determines the number, qualifications, pay standards and the working locations of the secondees.

The first three factors focus on whether the Home Entity would gain any financial benefits from the secondment arrangement. It implies that even the charge of reasonable administrative costs incurred by the Home Entity could lead to the potential creation of an E&P/PE in China.

The fourth factor should be welcomed by some multinational groups. It is not uncommon to see that the Chinese partner would disagree for the joint venture company to take up the full cost of the secondees from the foreign partner. Thus the Home Entity has to partially bear the cost of the secondees. It is good that the SAT does not simply take such circumstance as unfavourable to the Home Entity as long as IIT has already been paid on the income borne by the Home Entity. Having said the above, the term "fully paid" in the fourth factor can be challenging for some circumstances. For example, what if a secondee concurrently needs to take overseas trips to fulfil his overseas duties and settles his IIT on a time-apportionment basis?

According to the SAT's interpretation, if the Home Entity is assessed as the economic employer of a secondee based on the overriding principle, the presence of any of the five supplementary factors would lead to the conclusion that an E&P/PE exists in China for the Home Entity. However, it remains to be seen how the local-level tax authorities would, in practice, assess cases where the Host Entity (instead of the Home Entity) is proved to be the economic employer according to the overriding principle, but, at the same time, any of the five factors are pointing to the contrary. We hope their practice will be holistic in its approach, rather than hooking on one or two factors.

V. Other clarifications

Public Notice 19 also sets out the detailed documents and information[6] that the in-charge tax authorities have to examine in assessing the nature of the secondment arrangement. In particular, it reminds the tax authorities to look into any disguised/hidden transactions on payments relating to the secondment arrangements, such as offsetting transactions, waiving debts, related party transactions, etc. In other words, simply netting off inter-company account receivables and account payables would not help to avoid the issue. Besides, the "economic substance" and "implementation status" of the arrangement will also be reviewed. Overall, these practical guidelines are seen as fair and less burdensome to the relevant parties of the secondment arrangement.

It is a welcomed clarification that, if the Home Entity sends personnel to the Host Entity merely for exercising the shareholders' rights (e.g. attending shareholders' meetings or board meetings, etc.), the Home Entity would not be taken as having created an E&P/PE in China. However, it is important to consider whether the relevant cost of these personnel would be eligible for tax deduction at the level of the Host Entity and/or the Home Entity.

Public Notice 19 requests that the in-charge State Tax Bureau (STB), which looks after the CIT, exchanges information about the secondment arrangement with the in-charge Local Tax Bureau (LTB), which looks after IIT and Business Tax (BT). Once the STB determines that the arrangement is of the nature of service, the LTB would levy BT of 5% on the gross "service fee" which would be an additional tax burden to the Home Entity. The issue may become even more complicated if the Host Entity is located in the pilot cities in China currently implementing the "BT to Value Added Tax Transformation Pilot Programme".

VI. Concluding remarks

Public Notice 19 will become effective on June 1, 2013. Any outstanding cases will be handled in accordance with Public Notice 19. Hence, it is possible that the local-level tax authorities would open the cases that had not been agreed in the past and revisit the Home Entity's Chinese tax treatment.

Parties involved in secondment arrangements should review the existing arrangements with reference to this latest guidance to assess the risk level and consider if a restructuring of the arrangement is necessary. If the Home Entity incurs significant administrative costs for supporting the secondment arrangement and has to recover such costs from the Host Entity in China, it is advisable to consider how the charging mechanism be established without affecting the assessment of the nature of the secondment arrangement.

Good documentation is always important in substantiating the genuine nature of a secondment arrangement, bearing in mind the onus of proof lies with the Host Entity, the Home Entity and the secondees. Emphasis shall also be put on the actual implementation of the secondment arrangement to demonstrate the Chinese entity has the characteristics of an economic employer.

For those foreign companies who have entered or are going to enter into both a secondment arrangement and a service arrangement from their Chinese affiliates, it is imperative for them to clearly separate those expatriates who are under the secondment arrangement with those who are under the service arrangement as supported by both documentation and actual implementation. As such, the secondment arrangements will hopefully not be tainted by the service arrangement.

Public Notice 19 is newly issued. As is always the case in China, it will take some time for the local-level tax authorities to become familiar with the principles and guidelines provided therein, and consider how to implement them in their practice. The parties to the secondment arrangements are advised to stay tuned with the local implementation and practice of Public Notice 19.

Finally, Public Notice 19 may be able to resolve the question of whether it is a "secondment" or "service". However, whether or not to charge and how much to charge is actually more than a question of CIT exposure arising from E&P/PE. In fact, it has to be assessed from all the angles of transfer pricing, tax compliance efficiency, foreign exchange feasibility and business strategy so as to strike the right balance.

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NOTES

[1] "Home Entity" refers to the foreign entity which dispatches the expatriates to China.

[2] "Host Entity" refers to the Chinese entity where the seconded expatriates actually work.

[3] "Establishment and place" is a concept in Chinese Corporate Income Tax Law. A foreign enterprise is liable to Chinese Corporate Income Tax, if it has an establishment and place in China.

[4] The PE concept is a typical concept in the context of a Double Tax Agreement (DTA).

[5] SAT Guoshuifa Circular 75, which was issued in July 2010, provides guidance on the interpretation and implementation of the China–Singapore DTA. Meanwhile, it also applies to other DTAs concluded by China if the provisions in those DTAs are the same as those in the China–Singapore DTA.

[6] Documents include secondment agreements, internal policies regarding the secondees, accounting treatment, IIT payment, etc.

In Brief

India

Proposed tax on buyback of unlisted shares

The buyback of shares was facilitated by the Companies (Amendment) Act (21/1999) which allowed companies to purchase their own shares from their shareholders, thereby reducing the issued share capital of the company. This proved to be a very popular method of distributing funds to shareholders when a company had excess cash and wanted to mitigate the tax it would be subject to through the distribution of dividends.

Indian companies have utilised the buyback of shares method in order to reduce the taxes payable on the distribution of dividends to its shareholders, effectively reducing the number of shares available for trading and thus improving their share price, and as a way to block hostile takeover bids.

Companies Bill implications

The Companies (Amendment) Act Section 77-A allowed Indian companies to repurchase their shares once a year – if the repurchase was approved by the board – notwithstanding any other provisions in the Act. A buyback could previously be performed for up to 25 percent of the paid-up capital of the Indian company in that financial year. The buyback method was widely used by Indian companies and provided its board with a mechanism to interfere in the shareholding of the company.

In 2012, the Lower House of Parliament introduced the Companies Bill which proposed substantial changes to the buyback of shares procedure carried out by numerous Indian companies. There were stricter limitations imposed on the buyback of shares. One of the key changes included in the Companies Bill, is that it clearly outlined that a second buyback offer for shares that exceeded 10 percent of the paid up share capital of the company would only be carried out if a period of one year had passed from the date of the last offer.

The existing legislation permitted a company to carry out two buyback offers if the shares being repurchased did not exceed 25 percent of the paid-up share capital.

Furthermore, the Companies Bill proposed higher penalties if companies breached the legislation when carrying out the buyback of their shares. Another key change proposed by the Companies Bill was that a securities premium account could be included in the free reserves of a company, which augments the pool of funds that can be utilised to perform share buybacks. The Companies Bill is currently pending approval by the Upper House of Parliament.

Tax implications

The Indian Finance Minister presented the annual budget for 2013–2014 on February 28, 2013 and included a new proposed chapter in the Income Tax Act "Chapter XII-DA Special Provisions Relating to Tax on Distributed Income of Domestic Company for Buyback of Shares" which imposes a tax under section 115QA in the hands of the company. The amendment will be effective from June 1, 2013.

Previously the buyback of unlisted shares was tax free as it did not qualify as a dividend payment, as defined in Section 22(d) of the Income Tax Act 1961. Therefore, since the consideration paid to the shareholders was not treated as dividends, global investors could utilise the buyback of shares method to distribute funds exempt from tax. The buyback method was more attractive than the distribution of dividends, which are normally subject to a dividend distribution tax rate of approximately 15 percent plus any surcharge or education cess.

The proposed tax on the buyback of unlisted shares taxes the distributed income/net consideration (which is calculated as the difference between the amounts paid as consideration for buying back the unlisted shares, and the consideration received by the company when issuing these shares) at a rate of 20 percent. This tax would be imposed on the company which is buying back its shares. Buyback receipts which are taxed in the hands of the company would not be subject to tax at the shareholders' level.

Under the existing legislation the consideration received by a shareholder on the buyback of shares was taxable as a capital gain under section 46A of the Companies Act. Under various Indian double tax treaties, including those with Mauritius and Singapore, shareholders are permitted to claim capital gains tax exemption on the buyback of shares in an Indian company.

One of the key implications of the proposed buy-back share tax is that by taxing the buyback of shares in the hands of the company, it neutralises the benefit of the capital gains tax exemption which is available under various India double tax treaties, including those with Mauritius and Singapore.

Conclusion

The Companies (Amendment) Act which facilitated the buyback of shares in Indian companies was initially implemented to boost the Indian capital markets and attract investment, yet the restrictions proposed in the Companies Bill coupled with the tax on buyback shares/securities has tax and legal implications which may impact global investors' structures for investments into India.

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India

Tax on gains on the sale of a privately-held Indian company: An unnecessary controversy

India's income tax law was amended in 2012 to introduce a special tax rate of 10 percent (*plus* the applicable surcharge and cess) on gains derived from the transfer of unlisted securities by foreign companies and other non-residents. The general rate applicable to gains from the sale of shares of an Indian company is 20 percent (*plus* the surcharge and cess). The 10 percent and the 20 percent rates apply only to long-term capital gains, i.e. gains on shares that have been held for more than 12 months.

Some controversy has arisen in professional circles over whether the concessional rate of 10 percent would apply to gains derived from the sale of shares of a privately-held Indian company. The law provides that the 10 percent rate applies to the transfer of "unlisted securities," the term that has given rise to the controversy.

In lay terms, the shares of a privately held company clearly are regarded as unlisted securities. Under the legal definition of the term in Indian tax law, unlisted securities are defined to mean securities other than listed securities. Listed securities are those listed on a recognised stock exchange in India.

The term "securities" is borrowed from the Securities Contracts (Regulation) Act (SCRA), legislation designed to prevent undesirable transactions in securities. The SCRA, which deals with stock exchanges, the listing of securities, etc., defines the term "securities" to include shares, scrips, stocks, bonds, debentures, debenture stock and other marketable securities of a similar nature. In some court decisions involving the SCRA, the concept of "marketability" has been accorded significance in the interpretation of the term securities. On the basis that the definition of securities refers to "marketable securities," there has been some suggestion that, since the shares of a private company are not marketable, they do not qualify as securities and, therefore, are not eligible for the concessional 10 percent tax rate.

An interpretation that shares are *not* securities is misplaced for several reasons. First, the SCRA essentially only deals with listed securities and the focus on marketability must be understood in that context. It is relevant to note that the Indian Supreme Court has observed that the definition of securities in the SCRA includes all types of securities as commonly understood. Second, a conclusion that shares are not securities would lead to absurd results, for example, that employee stock options of private companies might not be taxable under the provisions specifically enacted for the purpose, which is clearly not the legislative intent. Third, the use of the terms "share" and "security" in a provision dealing with the holding period for determining whether capital gains are short-term or long-term in nature indicates that securities include shares. Finally, if marketability is a prerequisite for qualifying as a security, only shares that are marketable and are unlisted (or listed outside India) would qualify for the concessional tax rate. The twin conditions of a security being marketable but unlisted appear to be contradictory and self-defeating, and this is not what was envisaged by the Finance Minister.

At the time the Minister proposed the change to the law to grant a concession to non-residents, he noted that long-term capital gains derived by foreign institutional investors (FIIs) from the sale of unlisted securities were taxed at a rate of 10 percent, while a 20 percent rate applied to other non-resident investors, including private equity investors. The Minister proposed to reduce the rate to 10 percent to level the playing field and this rationale was also included in the Supplementary Memorandum explaining the amendment.

It is relevant to note that private equity investors typically invest in unlisted companies. Moreover, other foreign companies that set up operations in India through a corporate entity also generally use a private limited company structure. Thus, the concessional 10 percent rate clearly was introduced to apply to investments in the shares of private limited companies, so it is difficult to understand why that rate would apply to gains on the transfer of such shares.

With respect to the computation of capital gains, in cases where the 20 percent rate applies, the gains are computed in foreign currency and then converted into Indian rupees. This mechanism does not operate where the special 10 percent rate applies, i.e. in these cases, the capital gains are computed in Indian rupees.

There has been considerable debate about the routing of investments into India using Mauritius as an intermediary holding jurisdiction, especially with the general anti-avoidance rule coming into effect in the near future. Against this background, the move to levy capital gains tax at 10 percent on the disposal of shares of an Indian company is a welcome measure, since it may encourage investors to make investments directly into India, without using the Mauritius route. Investors setting up operations in India need certainty as to how those operations will be taxed; the controversy relating to the applicability of the 10 percent

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rate to the disposal of shares of private limited companies is an unnecessary distraction.

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Philippines

Developments in income tax on casino and gaming operators

The Philippine Government's push to capture a larger slice of global gaming revenues has encouraged greater investment from local casino owners who, increasingly, are partnering with internationally-renowned casino management companies. At the forefront of this push is the Philippine Amusement and Gaming Corporation (PAGCOR), the government owned and controlled corporation (GOCC) that is authorised to operate, grant licenses to operate, and regulate gaming facilities and games of chance in the country.

Under generous fiscal concessions granted in the 1970s by the then President Ferdinand Marcos, PAGCOR's tax privileges were extended to its licensees and other parties with which it had contracts. However, subsequent amendments to the National Internal Revenue Code involving PAGCOR's tax status, a 2012 Supreme Court decision and a recent issuance by the Bureau of Internal Revenue (BIR), have had the result of limiting these privileges.

PAGCOR was created by Presidential Decree (PD) 1067-A and by PD 1067-B, which were issued on January 1, 1977. Both laws exempted PAGCOR from the payment of all types of tax, except for a franchise tax of 5 percent of gross revenue. PD 1399 later expounded on the scope of PAGCOR's exemption. PD 1869 consolidated these various laws and continues to exist as PAGCOR's charter. Under Section 13(2)(b) of PD 1869, the favourable tax treatment granted to PAGCOR extended to corporations with whom PAGCOR has: ". . .any contractual relationship in connection with the operations of the casinos authorised to be conducted under [the PAGCOR charter] and to those receiving compensation and other remuneration from [PAGCOR] as a result of essential facilities furnished and/or technical services rendered to PAGCOR. . ."[1]

Present contractual arrangements between PAGCOR and its licensees or contractors have the cost of the franchise tax as part of the licence fees.

Interestingly, PAGCOR's favourable tax treatment is enjoyed not just by its licensees, but also by any other entity with which PAGCOR has a contractual relationship. Thus, in Ruling DA-268-00 (June 26, 2000), the BIR "confirmed the extension of the exemptions enjoyed by PAGCOR" to a marketing consultancy company that PAGCOR hired to promote the game of Jai-alai.

On January 1, 1998 the present National Internal Revenue Code[2] (the Tax Code) took effect. Section 27(c) of the Tax Code subjected GOCCs to corporate income tax, but exempted a select few from having to pay the tax. One of these GOCCs was PAGCOR. However, in November 1, 2005 the Republic Act (RA) 9337 amended the Tax Code but omitted to enumerate PAGCOR with a list of GOCCs that are exempt from income tax. RA 9337 – primarily a law that overhauled VAT but nonetheless touched on some of the Tax Code's income tax provisions – went on to survive a constitutional challenge in the Supreme Court. On September 1, 2005, upon the promulgation of the Supreme Court case upholding the validity of RA 9337, the BIR issued Revenue Regulations (RR) 16-2005. Buried in the regulation's provisions was the imposition of VAT on PAGCOR and its licensees. PAGCOR then filed a lawsuit against the BIR with the Supreme Court to challenge the VAT and income tax on it.

PAGCOR vs. the Bureau of Internal Revenue[3]

The Supreme Court ruled that PAGCOR is subject to income tax – presently set at 30 percent of net income – and noted that legislative records indicate that this was indeed the intent of congress. The Court explained that PAGCOR's franchise to operate, maintain and license gaming operations may be amended, altered, or repealed by congress. This includes the income tax exemption of PAGCOR, which RA 9337 validly repealed.

On the other hand, the Court prevented the BIR from imposing VAT on PAGCOR. The Court clarified that RA 9337 did not affect PAGCOR's exemption from taxes other than income tax. In other words, RA 9337 did not revoke the exemption from all other taxes granted by PD 1869, the PAGCOR charter. This was the second time that the Court had occasion to rule on the VAT on PAGCOR, its licensees and contractors: in *Commissioner of Internal Revenue vs. Acesite (Phils.) Hotel Corp* (G.R. 147295, February 16, 2007) it ruled that both PAGCOR and its licensees or contractors are exempt from VAT.

Revenue Memorandum Circulars

As guidance to internal revenue officers, the Commissioner of Internal Revenue (CIR) issued Revenue Memorandum Circular (RMC) 8-2012, which quoted the relevant portions of the Supreme Court's decision, subjecting PAGCOR to income tax. PAGCOR paid income taxes for the tax years 2011 and 2012, making it to the BIR's list of top 500 non-individual taxpayers for 2011.

The CIR then followed this up with RMC 33-2013, which took effect on March 1, 2013. The circular summarized the taxes that are applicable to PAGCOR *and* its licensees or contractors. It is this circular that states that PAGCOR's licensees or contractors are subject to income tax.

Below is a summary of the present tax regime of PAGCOR and its licensees or contractors post-RMC 33-2013.

Taxpayer	Income Tax	Franchise Tax	VAT	Other Taxes
PAGCOR	Yes, for all income (whether or not the income is connected to gaming operations and/or licensing)	Yes for all income connected to gaming operations and/or licensing	No	No
Licensees or Contractors	Yes	Embedded in current PAGCOR licences/contracts	No	No

The tax on income of PAGCOR licensees or contractors comes at an important time in the Philippine gaming industry's development. PAGCOR has so far granted licenses to four casino operators, all of which will be located in the so-called Entertainment City, which sits on reclaimed land along Manila Bay and that PAGCOR envisions to be Asia's next gaming destination.

Gaming analysts and investors are watching developments closely to see what PAGCOR will do next. News reports quote senior PAGCOR officials as saying they will engage in discussions with the BIR to reconsider its stance. Industry players have also stated that they will collectively file a position paper with the BIR. Whether the BIR will agree with their position is, of course, another question.

Like many tax authorities the world over, the BIR has stepped up their collection efforts, and will not just ignore the gaming business. Industry players have also indicated that they may move for the cancellation of the franchise tax cost component that is currently embedded in the license fees they remit to PAGCOR. Irrespective of the course of action it is important that the result will not impede the growth of the gaming industry in the Philippines.

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The views and opinions expressed herein are those of the author and do not necessarily represent the views and opinions of KPMG in the Philippines.

NOTES

[1] PAGCOR briefly lost its tax exemption from June 11, 1984 when it was withdrawn under PD 1931, to September 28, 1984 when it was restored under Letter of Instruction 1430.

[2] Republic Act No.8424.

[3] G.R. 172087 (March 15, 2011)

Singapore

GST rules for exports of goods have been revised

GST was introduced in Singapore on April 1, 1994, with the tax imposed at a standard rate of 3 percent on nearly all transactions that involve the supply of goods and services in the course or furtherance of a business. The rate has increased over the years and is now at 7 percent with effect from July 1, 2007.

GST is generally chargeable at the standard rate on a supply of goods in Singapore. A supply of goods is zero-rated only if the goods are exported and prescribed export documents are obtained with the required timeframe and maintained to substantiate the movement of the goods. In this respect, the Inland Revenue Authority of Singapore (IRAS) has published guidelines on the prescribed export documentation that must be maintained to satisfy the conditions for zero-rating exported goods. The guidelines, which are found in the IRAS e-Tax guide *A Guide on Exports*, cover the various scenarios under which exports of goods may be made, and the types of export documentation required by the IRAS under the respective scenarios.

The primary intention of the guidance is to ensure that there is consistency in terms of the export documentation that is required to support the zero-rating treatment for an export supply of goods. In fact, the guide that has been issued by the Singapore tax authority is not new as the First Edition was issued back in August 1994: the year that GST was implemented in Singapore. We now have the Eleventh Edition which means that over the years, the tax authority has been updating the guide for new export scenarios that it has come across or have been brought to their attention.

Apart from new scenarios, updates are made periodically to consider the implications arising from the introduction of new GST schemes or for changes in GST rules affecting the zero-rating of goods. The key changes in recent years involved the introduction of the Hand-Carried Exports Scheme in April 2009 and changes to the GST treatment for ship and ship-related supplies following announcements made in the 2010 Budget Statement.

The implementation of the Hand-Carried Exports Scheme has placed an additional obligation for GST-registered businesses to apply for an export permit before goods can be hand-carried from Singapore via the Singapore Changi Airport. On the other hand, the changes relating to ship and ship-related supplies expanded the scope of zero-rating and at the same time, the export documentary requirements were largely "relaxed" to acknowledge the commercial reality and difficulties. For instance, for a supply of goods to be used or installed on a ship in Singapore, one no longer needs to produce evidence that the goods are physically installed on board the ship before zero-rating treatment can be applied.

Due to the nature of export transactions, the Singapore tax authority has taken care to ensure that the relevant Singapore Customs requirements are reflected or updated in the guide. For example, the guide has been updated for the new Singapore Customs requirement that export permits have to be obtained and submitted for all export of goods (via the different modes of transport). This requirement, known as the "Advance Export Declaration", was previously only applicable to exports of goods via land transport.

By and large, GST-registered businesses have been able to comply with the export documentation re-

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quirements that are prescribed in the guide. Businesses are appreciative that the guide has provided a degree of certainty as to the types of export scenarios where zero-rating can apply. The guide has also been helpful as an authoritative reference during difficult conversations with customers in situations where the business has to explain why zero-rating treatment cannot apply to a particular transaction.

On the other hand, the export documentation rules in the guidance are administered quite strictly by the tax authority. Failure to satisfy the requirements can result in the zero-rating treatment being revoked and for the export transaction to be subject to GST at the standard rate of 7 percent.

For such cases, there is an avenue for the taxpayer to seek a ruling from the Singapore tax authority for a variation of the rules if there are strong commercial grounds to support the request. What is important is for the business to demonstrate that it has an adequate audit trail to show that the goods are exported and taken out of Singapore.

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Taiwan

Royalties paid in 2011 and thereafter for foreign patents may be exempt from Taiwan income tax

According to the Income Tax Act, royalties and technical service fees received by a foreign entity for providing its patents, trademarks, and special technologies to a Taiwan entity are, in general, subject to 20 percent tax which must be withheld by the Taiwan entity upon making the payment, unless tax exemption approval is obtained.

Tax exemption on royalties for Taiwan patents

As part of the plan to elevate the value of domestic industries, the Taiwan government grants certain tax incentives to encourage technology transfers from overseas; for example, income tax exemption on royalties received by a foreign entity for licensing its patents, trademarks, know-how or other licensed rights to a Taiwan entity, if certain criteria are met. These criteria are prescribed under the *Rules on the Screening of Applications for Exemption from Income Tax on Royalty Payments and Technical Services Fees Collected by Foreign Profit-Seeking-Enterprises* (**Exemption Rules**), last amended on July 6, 2007.

Under the No. 5 of the current Exemption Rules, royalties that are eligible for tax exemption are limited to those for patent rights that have been approved by the Taiwan Intellectual Property Office. As a result, in practice, foreign entities may include income tax cost in royalties, in which case, the actual cost to Taiwan entities is increased.

Tax exemption on royalties for foreign patents starting from 2011

In order to further encourage the transfer of foreign technologies and reduce the burden on Taiwan entities, the Ministry of Finance and the Ministry of Economic Affairs have been discussing the revocation of the tax exemption criteria and expanding the scope of tax exemption prescribed under the Exemption Rules for around two years. They have finally reached a consensus on expanding the scope of tax exemption on royalties paid for foreign patents, while the criteria for tax exemption still apply.

Under the revised Exemption Rules which will soon take effect, royalties paid for foreign patents will also be exempt from income tax, and such exemption will apply retroactively to such royalties paid in 2011 and thereafter, provided that the following criteria are met.

Criteria for tax exemption on royalties for foreign patents

The patent rights licensed are duly registered with the competent authorities of a foreign jurisdiction and are valid.

The licensing must be for a technical cooperation project. The term “technical cooperation” refers to a case where a foreign licensor licenses a Taiwan entity the right to use its patent for any of the following purposes:

- The licensing arrangement will facilitate the Taiwan entity’s production of new product(s);
- The licensing arrangement will increase production volume, improve quality or reduce production cost of the Taiwan entity;
- The licensing will facilitate the Taiwan entity’s development of new production techniques; or
- The market for the licensed product(s) under a technical co-operation project is not limited to Taiwan.

Technical service fees

As a trade-off, the tax exemption on technical service fees for special technologies, as prescribed under Point No. 7 of the current Exemption Rules, will be cancelled. In which case, an application for applying a lower withholding tax rate (3 percent instead of 20 percent) is worth considering.

Procedures for applying for tax exemption

An application must be filed by either the foreign licensor or the Taiwan licensee with the Industrial Development Bureau of the Ministry of Economic Affairs for its issuance of a letter confirming that the Exemption Rules apply to the subject case. Upon receipt of said letter, the applicant should file another application with the local branch of the National Tax Bureau where the licensee is located for its issuance of a letter confirming tax exemption approval. After obtaining these two approvals, the royalties payable to the foreign licensor will be exempt from tax, and the Taiwan licensee will no longer need to withhold any income tax upon paying such royalties.

The Ministry of Finance and the Ministry of Economic Affairs will jointly publish the revised Exemption Rules shortly.

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Thailand

Extension of 7 percent VAT rate

The normal value added tax (VAT) rate of Thailand is 10 percent, but has been temporarily reduced to 7 percent over periods of time. As the corporate income tax rate has been temporarily reduced from 23 percent in the fiscal year 2012 to 20 percent in the fiscal years 2013 and 2014, there had been anticipation in 2012 that the reduction of the VAT rate to 7 percent might not be extended for another period of time, and the normal 10 percent rate would be applicable. (The 7 percent VAT rate expired in September 30, 2012.)

Taking into account the floods in Thailand in 2011, which dramatically affected the employment rate and local consumption, the Thai Government issued the Royal Decree No. 549 in October 2012, to extend the reduction of the VAT rate from 10 percent to 7 percent for another two years. The 7 percent VAT rate will expire on September 30, 2014. It is believed that the extension of the reduction in VAT will increase the local consumption and reduce the cost of living of consumers. From October 1, 2014, the VAT rate will technically return to 10 percent; however, it is expected that the 7 percent rate will again be extended at that time.

Launching e-tax invoicing

In compliance with the e-Government policy, the Revenue Department has recently permitted VAT operators to issue electronic invoices and tax invoices (e-tax invoices) instead of paper tax invoices which have to be delivered to the customers physically. This encourages entrepreneurs to use e-tax invoices and helps VAT operators reduce business operation costs.

To regulate the issuance of e-tax invoices systematically, the Revenue Department issued a tax regulation in 2012 regarding "the preparation, delivery and storage of e-tax invoice and e-receipt." Under the regulations, VAT operators must satisfy the following criteria.

1. The VAT operator must be a limited company or public limited company with paid-up registered capital of at least Baht 10 million;
2. The VAT operator must have stability and credibility within the business operations. For example, it must have a good tax payment history, must not have any tax avoidance behaviour, must not use counterfeit tax invoices in the past, or must have more net assets than net liabilities;
3. The VAT operator must have proper accounting systems and security systems necessary to accommodate and implement a secured e-invoicing system; and
4. The VAT operator must have a good internal control system which is able to prove that the e-tax invoices and receipts prepared and sent to recipients are complete and accurate.

To implement the e-invoicing system, the VAT operator must have its first digital signature (which is to be created by the software of the Revenue Department) and the second digital signature certified by a Certification Authority. A submission of e-invoicing application to the Revenue Department and an approval of the Director-General of the Revenue Department is needed before the VAT operator can issue e-tax invoices/invoices.

The first Thai VAT operator approved by the Revenue Department to issue e-tax invoices was Thai Digital ID Co., Ltd., which is also authorised to be a Certification Authority (CA) to certify the correctness of e-receipts and tax invoices and digital signatures.

Abolition of VAT exemption on sales of locally-produced cigarettes

Manufacturing cigarettes in Thailand is a monopoly business. Cigarettes sold in Thailand are manufactured by the Tobacco Factory which is a government-owned business. Resellers or distributors selling locally-produced cigarettes and imported cigarettes also hold different licenses. Before October 15, 2012, sales of locally-produced cigarettes were exempted from VAT, while VAT was imposed on sales of imported tobacco. It may be concluded that the locally-produced cigarettes received preferential VAT treatment over the imported cigarettes until a recent ruling regarding Thai government's violation of the GATT 1994.

On June 17, 2011, the World Trade Organization (WTO) by its Appellate Body upheld the Panel's opinion that Thailand acts inconsistently with Article III: 2 and 4 of the GATT 1994, by subjecting imported cigarettes to internal taxes in excess of those applied to like domestic cigarettes and granting exemption from VAT for resellers of locally-produced cigarettes together with the imposition of VAT on resellers of imported cigarettes when they do not satisfy prescribed conditions obtaining input tax credits necessary to achieve nil VAT liability.

After the Thai government expressed its intent to implement the rulings of WTO on August 11, 2011, with effect from October 15, 2012 onwards Thailand implemented the WTO rulings/obligations by issuing Royal Decree No.533 to revoke the VAT exemption on sales of locally-produced cigarettes.

Therefore, VAT is now chargeable on domestic sales of all imported and locally-manufactured cigarettes.

Transfer of future cashflow - a taxable supply for VAT purpose or disguised financing for specific business tax purpose?

Among transactions involved in an establishment of the infrastructure fund (Fund), the spotlight is currently focused on VAT treatments on the transfer of future cashflow to the Fund at discount. The ruling of the Revenue Department issued in August 2012 held that the cash proceeds received by the transferor of the future cashflow is treated as a similar loan transaction under which the cash proceeds received by the transferor from the Fund are not taxable income in the hand of the transferor. The discount given by the transferor to the Fund is therefore treated as a disguised interest payment and chargeable to 3.3 percent specific business tax (SBT) similar to loan interest.

Royal Decree No. 544 grants exemption for VAT, SBT, and stamp duty in certain transactions involved in establishment of the Fund which includes:

1. exemption for asset owners on transactions relating to the transfer of assets to the fund; and
2. exemption for the fund on transactions relating to the transfer of assets back to original owners.

Without any doubt, the above exemptions do not cover the SBT levied on the discount (disguised interest) obtained by the Fund because it was not derived from the transfer of assets back to the original owner.

Uncertainty arises as to whether the transfer of future cashflow is considered to be a supply of goods which is subject to VAT (unless exempted), rather than a financing transaction similar to the loan.

Had the transfer of future cashflow been treated as a "sale" or a "supply of goods" for VAT purposes, the next question is whether or not the cash proceeds received by the asset owner would be exempt from VAT under (1) above. Advisors should follow-up closely on future developments and interpretations towards VAT and SBT treatments on the transfer of future cashflow transactions.

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