# A rapidly changing tax landscape
## Recent Asian tax developments

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The tax environment in Asia continues to evolve. The diversity of tax systems in Asia (and their differing maturity) notwithstanding, there are a number of broader trends in Asian tax that can be discerned.

**These include:**

- Indirect tax reform such as the introduction of the Malaysia Goods and Services Tax (GST) in 2015 and the recent expansion of the China Value Added Tax (VAT) to cover the financial services industry; we have seen developments in Japan and South Korea, and the India GST reform is pending
- Monitoring of *Base Erosion and Profit Shifting* (BEPS) developments and adoption of recommendations—although the rate of adoption varies across the region with a clear group of fast movers (e.g., Australia, China, Japan and South Korea)
- Support for tax transparency initiatives
- Consistent with the Organization for Economic and Co-operation and Development's (OECD) BEPS objectives, the introduction of measures to protect the integrity of the domestic tax base

In this article we cover several recent developments in Asia that are directly relevant to asset managers.

## China: Transition to VAT

On 1 May 2016, the China VAT reform that began back on 1 January 2012 was completed, with the remaining industries—including financial services and insurance—transitioning from the Business Tax (BT) regime to VAT. A broad range of financial services will now be taxed at a VAT rate of six percent (versus the previous BT rate of five percent), although with an ability to deduct input VAT paid on expenses.[1] Financial services have been defined to include finance and insurance businesses, that is, loan services (lending and borrowing), fee-based financial services (including asset management services), insurance, and the transfer of financial products.

There is some roll-over of the current BT exemptions into the new VAT regime. Even with the inclusion of these exemptions, the scope of the China VAT on financial services is broader than what is found in other VAT jurisdictions. In China, imposing indirect tax on these activities is not new, as the VAT treatment aims to represent a continuation of the BT regime. In fact, the VAT applies to trading activities in a manner similar to a turnover tax, with the trading business required to calculate the VAT due based on the net realized gain, and any losses made can be carried forward to offset against the gain, but not beyond the same calendar year. This means that funds are brought into the VAT system as VAT taxpayers with few exemptions (e.g., QFII, RQFII, and other qualified foreign investors).

Although the move to VAT effectively reflects a roll-over of the existing BT approach into VAT, the one percent increase in rate (from five percent to six percent) must be fully assessed and costed in terms of the impact to margins and pricing. In particular, although VAT is intended to be imposed on the customer, commercially this can be challenging. Since the BT was previously absorbed by the business, in effect this can result in an additional one percent cost.

While entry into the VAT regime means that there is the ability to recover VAT paid on expenses, this cost is not entirely removed. The China VAT regime operates with multiple rates (from 3 percent to 17 percent); in scenarios where the input VAT exceeds the output VAT, refunds are generally not paid in cash refunds and need to be carried forward. If an exemption applies, the input VAT would not be recoverable and therefore the VAT on asset management services paid by exempt funds would be a cost.

The transition to VAT also brings in the scope for VAT exemption for export services on asset management services to parties outside of China. The relevant in-charge tax bureau must approve the exemption, although the application procedures still need to be clarified. Businesses and the tax authorities are still grappling with some of the technical and practical issues in the shift to the new regime. We expect that there will be more developments in the coming months.

## Hong Kong Profits Tax (HKPT) Exemption changes

In 2015, the HKPT exemption for offshore funds to non-resident private equity (PE) funds, called the Offshore Funds Law, was extended. Previously, tax exemption was not available to non-resident funds on transactions in securities of private companies. In effect, this excluded non-resident PE funds from enjoying HKPT exemption under the Offshore Funds Law. In order to enhance Hong Kong's position as an asset management center, the extended Offshore Funds Law introduces various concepts that will allow PE funds to also benefit from HKPT exemption.

**Broadly, the key changes are:**

- Transactions in securities in certain private companies that fall within the definition of an "excepted private company" are tax exempt "specified transactions": Broadly, such an excepted private company has to be an offshore portfolio company incorporated outside HK that meets the conditions within a three year "lookback" period, including not having a permanent establishment in HK and the 10 percent "de minimis" thresholds on its HK assets.

1 Note that input VAT deduction is not allowed on interest expenses and direct loan related fee expenses.

- Qualifying fund: Prior to the extension of the Offshore Funds Law, specified transactions have to be arranged or carried out by a "specified person" in order to be HKPT exempt. A specified person generally refers to a person licensed under the Securities and Futures Ordinance, by the Securities and Futures Commission (SFC). A non-resident PE fund may not necessarily have an SFC-licensed person undertake such transactions. With the extension of the Offshore Funds Law, a non-resident PE fund that is not managed by an SFC licensed person may also enjoy HKPT exemption if it meets certain conditions (e.g., a minimum of five investors apart from originators and their associates, or capital commitments made by unrelated investors exceeding 90 percent of the fund's aggregate capital commitments).
- Special Purpose Vehicle (SPV): Recognizing that a PE fund typically uses an SPV to hold its investments, HKPT exemption would be provided to an SPV on its profits derived from transactions in certain securities of an interposed SPV or an excepted private company (such as gains from the disposal of an offshore portfolio company). The SPV must be established solely for the purpose of holding and administering one or more offshore portfolio companies.

The new legislation was widely anticipated and enables key investment activities such as the negotiation, conclusion, and execution of the acquisition and disposal of investments to be carried out in HK by fund managers in HK without causing the fund's profits to be sourced in HK and subject to HKPT.

On 31 May 2016, the Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 51 (DIPN 51) to clarify the key provisions. However, in DIPN 51, the IRD also sets out its position on fund management fees and carried interest, which has been a focal point of recent tax investigations and audit in HK. The IRD stated that it does not likely consider a cost plus basis of remuneration of a HK sub-manager/investment advisor in HK to be an arm's length rate, and, if applying the general anti-avoidance provisions of the Inland Revenue Ordinance of HK, carried interest may be attributed to their services rendered and subject to HKPT unless the return is an arm's length return on genuine investment.

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Carried interest received by fund executives who provide services in HK by way of distributions from the fund's general partner or carried interest partner may also be caught by the general anti-avoidance provisions and subject to HK tax as employment income or service fee. An important consideration for fund managers is whether relying on the Offshore Funds Law to obtain HKPT exemption for their funds, thereby carrying on more fund management activities in HK, would adversely affect the taxability of fund management fees or carried interest.

### Singapore and Hong Kong join the OECD's BEPS Project as BEPS Associates

In June 2016, Singapore and HK announced that they will join the OECD's BEPS Project as BEPS Associates.[2]

### Singapore announcement

Singapore announced that it is committed to implementing the four minimum standards under the BEPS Project as an Associate. Singapore also detailed its position on the four minimum standards under the BEPS Project, as follows:

- Countering harmful tax practices (Action 5): While Singapore uses tax incentives to promote investment in certain areas, incentive recipients must have substantive operations in Singapore regularly review its tax incentives. Singapore has allowed some tax incentives to lapse and refined several others over the years.
- Preventing tax treaty abuse (Action 6): Singapore does not condone treaty shopping. A number of Singapore's bilateral tax treaties contain anti-treaty shopping provisions. Singapore is currently part of a group of jurisdictions working to develop a multilateral instrument for incorporating BEPS measures into existing bilateral treaties.
- Country-by-Country Reporting (CbCR) for transfer pricing documentation (Action 13): Singapore will commit to implement CbCR for financial years beginning on or after 1 January 2017 for multinational enterprises whose ultimate parent entities are tax resident in Singapore, and whose group turnover exceed S$1,125 million. IRAS will exchange CbC reports with jurisdictions that Singapore

2 The first meeting between BEPS Associates was held on 30 June to 1 July 2016, where the OECD announced that a total of 82 new countries and jurisdictions have joined as BEPS Associates. Another 21 countries and jurisdictions attended the meeting as invitees, and will consider whether to commit to the implementation of the BEPS package.

has entered into bilateral agreements with for automatic exchange of CbCR information. Further details are expected to be released by September 2016.

- Enhancing cross-border tax dispute resolution (Action 14): Singapore will work closely with other jurisdictions to monitor the implementation of minimum BEPS standards on dispute resolution

**Hong Kong announcements**

As an Associate, HK will join with other countries and jurisdictions to design, review and monitor the implementation of the four BEPS minimum standards. The Secretary for the HK Treasury Professor KC Chan stated: "…HK's commitment to implement the BEPS package is subject to timely passage of the necessary legislative amendments. We will take into account relevant factors such as the characteristics of the domestic tax regime, the envisaged magnitude of legislative changes involved, and the practical need to prioritize amongst the BEPS measures."[3]

It is expected that HK will engage with industry members to develop a strategy for implementing the relevant guidelines and protocol, and will release more information in the coming months.

**CRS implementation in the region**

The OECD CRS provides for the automatic exchange of information between tax authorities of signatory countries. Currently over 100 jurisdictions have committed to CRS, with the first exchange of information due to happen as soon as 2017 for "Early adopter" or "Wave 1" jurisdictions.

Within the region, India and South Korea are "Early adopters" or "Wave 1 jurisdictions". More commonly however, Australia, Brunei Darussalam, China, Indonesia, Japan, Macau, Malaysia, New Zealand, and Singapore have committed to CRS as "Non-early adopters" or "Wave 2 jurisdictions", with the first exchange due to happen in 2018.

The status of CRS implementation in each respective jurisdiction varies. Financial institutions will need to closely monitor local CRS developments in each jurisdiction where they operate.

Some recent key developments this year with respect to CRS implementation in the region include:

- Legislation to implement CRS in **Australia** was enacted in March 2016 and Guidance was released in April 2016.
- Legislative Council of the **HK Special Administrative Region** passed the HK Inland Revenue (Amendment) Bill in June 2016.
- Updated FATCA and CRS Guidance was released in **India** in May 2016.
- The National Tax Agency in **Japan** released unofficial Q&As in April 2016 to address questions from the industry.
- Inland Revenue in **New Zealand** released a CRS consultation document and submissions were due by March 2016.
- Legislation to implement CRS in **Singapore** was passed on 9 May 2016 and published in the gazette on 4 July 2016. CRS Regulations were also released in June 2016 for comments as part of a private consultation with the industry.

The majority of Asian countries have signed the Multilateral Competent Authority Agreement (MCAA) with the exception of Brunei Darussalam, HK, Macau, and Singapore. The MCAA specifies the details of what information will be exchanged and when.

3 Hong Kong Government Press Release dated 20 June 2016 available here: http://www.info.gov.hk/gia/general/201606/20/P201606200520.htm.

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**India addresses capital gains exemption under tax treaty with Mauritius**

On 10 May 2016, India and Mauritius signed a protocol to amend the existing 1982 tax treaty.

Currently, the India-Mauritius tax treaty provides that capital gains derived by an entity are taxable only in the state of residence of the seller. This forms the basis of the "Mauritius route": gains derived from a Mauritius company from the sale of shares in an Indian company are not taxable in India under the treaty. The most significant of the changes is that the protocol will grant India taxing rights over gains derived by a Mauritius company from the sale of shares in an Indian company. This will effectively close off the "Mauritius route" for investment into India. Investments made on or before 31 March 2017 may be "grandfathered" (i.e., the rules do not apply retrospectively) and a lower tax rate on capital gains applies during the two transition years ending on 31 March 2019.

Consistent with the changes negotiated to the India-Mauritius tax treaty, Cyprus announced on 30 June 2016 that it had completed negotiations to amend its tax treaty with India. The amendment provides a source-based taxation for gains from disposal of shares. Investments undertaken prior to 1 April 2017 would be grandfathered so that taxation of disposal of such shares at any future date remains with the contracting state of residence of the seller.

**Implications for the Singapore-India tax treaty**

The Singapore-India tax treaty provides that the capital gains tax exemption for Singapore residents on disposal of shares in Indian companies is conditional upon similar rights being available under the Mauritius-India tax treaty.

As a result of the changes to the Mauritius-India tax treaty, the residency-based taxation treatment under the Singapore-India tax treaty may not be available by 1 April 2017.

The respective Ministries of Finance are expected to commence negotiations on a new protocol to the tax treaty. While this will take time, the concerns of the industry and the need for certainty (especially around grandfathering) are well understood by the Singapore authorities.

**Alternative investment options**

Depending on the circumstances of each investor, a number of options for investment into India through Mauritius may still be available:

- As capital gains tax exemption continues in the India-Mauritius tax treaty for bond investments, and interest income is taxed at 7.5 percent, which is the lowest rate of any country with agreements with India, investors may consider structures involving participating loans.
- As gains arising from derivatives are exempt from Indian capital gains tax, portfolio investors (i.e., with investments of less than 10 percent) may continue to route derivative trades through Mauritius.
- PE investors may explore conversion of Indian companies into Limited Liability Partnership (LLPs), as alienation of interests in LLPs continue to be exempt under the India-Mauritius tax treaty (although we note there are some limitations to this, including restrictions on foreign direct investment in LLPs).
- PE investors may explore investing in partly paid-up shares prior to 1 April 2017 and bring-in balance funds (i.e., call money) within 12 months as required by the exchange control regulations in India.

India has a number of other tax treaties that provide exemption from capital gains tax in India.[4]

**General anti-avoidance rule (GAAR)**

The GAAR will commence on 1 April 2017. The GAAR provisions will only apply to transactions entered into on or after 1 April 2017.

## To the point:

- The tax environment in Asia continues to evolve and companies should monitor relevant developments and take action where appropriate.
- International tax reform and transparency continue to be important issues for investment managers.

4 See for example: Belgium (shareholding must be less than 10 percent); Denmark (shareholding must be less than 10 percent); France (shareholding must be less than 10 percent); Indonesia; Jordan (capitals gain to be subject to tax in Jordan); Kenya; Korea; Netherlands (shareholding to be less than 10 percent or sale of shares should be to a non-resident); Philippines; Sweden (capital gains to be subject to tax in Sweden); Zambia; Malaysia; and Spain (shareholding to be less than 10 percent).