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General tax update for financial institutions in Asia Pacific

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Tax update

Legislative developments

On 2 June 2011, Income Tax Assessment Amendment Regulations 2011 (No. 4) ("the Regulations") was introduced, although it is taken to have commenced on 26 March 2009, being the date the Taxation of Financial Arrangements (TOFA) regime was introduced. By way of background, the TOFA regime contains rules for the tax treatment of gains and losses from certain financial arrangements held by certain taxpayers. The hedging financial arrangements method is one of the four TOFA elective methodologies – it broadly outlines the tax treatment of gains and losses from hedging financial arrangements. Under this methodology, a taxpayer must have appropriate record-keeping documentation in place at, or soon after, the start of the hedging relationship or at such other time provided for in the Regulations.

The Regulations effectively introduced a temporary transitional concession that required taxpayers entering into hedging relationships prior to 30 June 2011 to have appropriate record-keeping documentation (rather than needing to have such documentation in place at, or soon after, the start of the hedging relationship). Accordingly, the Regulations state that the basis for allocating gains and losses from hedging financial arrangements for income tax purposes must be made or put in place by the later of the following:

- at or soon after the start of the hedging relationship
- 30 June 2011.

Given that the 30 June 2011 deadline has now passed, the benefit of this transitional concession is now effectively over, as going forward, taxpayers will need to have appropriate record-keeping documentation in place at, or soon after, the start of the hedging relationship (subject to further regulations being introduced).

On 29 June 2011, the Tax Laws Amendment (2011 Measures No. 5) Bill 2011 ("TLAB 5-2011") received Royal Assent. Broadly, TLAB 5-2011 contains provisions regarding the taxation of trust income, the streaming of capital gains and franked distributions, and anti-avoidance rules. TLAB 5-2011 includes amendments to ensure that, where permitted by the trust deed, the capital gains and franked distributions of a trust can be effectively streamed for tax purposes to beneficiaries by making them specifically entitled to those amounts. It is intended to:

- allow the streaming of capital gains and franked distributions, with their particular tax attributes, derived by a trustee to beneficiaries who are 'specifically entitled' to those categories of gains and income
- apportion the remaining amounts of the taxable income of the trust, including any capital gains and franked distributions to which a beneficiary is not 'specifically entitled', based on the beneficiaries' presently entitled share of the income of the trust estate.

The new provisions impose important record-keeping requirements. In particular, for the streaming of franked dividends, the provisions entrench the need for a trustee to resolve the distribution prior to the year end.

Specific anti-avoidance rules

Two specific anti-avoidance rules have also been introduced which prevent exempt beneficiaries from being used

inappropriately to minimise the tax payable in respect of the net income of a trust.

Broadly, the first rule treats an exempt entity that has not been notified of its present entitlement to the income of a trust within two months after the end of the year of income as not being presently entitled. Thus the trustee, rather than the exempt entity, would be liable for the tax payment relating to that present entitlement.

The second rule looks to circumstances where an exempt entity receives a disproportionate share of the trust's net income relative to its entitlement to the net accretions underlying the trust's net income.

Managed investment trusts

Managed investment trusts (MITs) are carved out from the new provisions, in recognition that these trusts generally do not stream capital gains or franked distributions. Nevertheless, the trustees of such trusts can choose to apply the new provisions for the 2011 and 2012 years of income, after which the new MIT regime is due to commence.

Furthermore, the anti-avoidance rules mentioned above do not apply to MITs, even if they so elect to apply the new provisions for the 2011 and 2012 years of income.

- As an update to Issue 38, on 29 June 2011 the Tax Laws Amendment (2010 Measures No. 5) Bill 2011 ("TLAB 5-2010") received Royal Assent.

  TLAB 5-2010 amends the 'capital protected borrowing' provisions. These provisions seek to ensure that a capital protected borrowing is treated as a loan and put option (i.e. the capital protected feature) for Australian tax purposes. As a consequence, a portion of the interest expense is effectively attributed to the cost of the put option (based on a 'benchmark interest rate') and may be characterised as capital in nature and therefore non-deductible.

  TLAB 5-2010 seeks to change the benchmark interest rate which is used to determine the cost of capital protection to the Reserve Bank of Australia's Indicator Lending Rate for Standard Variable Housing Loans plus 100 basis points.

  Broadly, the new benchmark interest rate will apply to capital protected borrowings entered into after 13 May 2008.

- On 28 July 2011, the Exposure Draft Tax Laws Amendment (2011 Miscellaneous Measures) Bill (No. 1) 2011: GST financial supply provisions ("the Exposure Draft") was released.

  The Exposure Draft proposes the following specific items relating to financial supplies with proposed effect from 1 July 2012.

  - The first limb of the financial acquisitions threshold (FAT) is to increase from AUD 50,000 to AUD 150,000. This new threshold means an entity can make up to AUD 1,650,000 of financial acquisitions in the relevant period before exceeding this limb of the FAT. This compares with up to AUD 550,000 of similar acquisitions under the current provision.

    The second limb of the FAT remains unchanged under the Bill. If a taxpayer's notional input tax credits for its current or future financial acquisitions exceed 10 percent of the total amount of notional input tax credits for all of its purchases during the relevant period, then the FAT will have been breached even if the dollar value of input tax credits is less than AUD 150,000.

  - Australian Authorised Deposit-taking Institutions (ADIs) making financial supplies consisting of a borrowing through the provision of deposit accounts will no longer be able to claim input tax credits for acquisitions that relate to the financial supply consisting of a borrowing, even where the borrowing relates to making supplies that are not input taxed.

    This proposed exclusion does not impact on other forms of borrowing, such as borrowings by ADIs in the form of debentures, even if these borrowings may be reflected in the accounting books in the form of an 'account'.

  - All taxpayers under a hire-purchase agreement will be able to claim input tax credits upfront. Previously, taxpayers who accounted on a cash basis were only eligible to claim credits when each instalment payment was made.

- On 16 August 2011, the Assistant Treasurer released the exposure draft legislation for public consultation, for the proposed taxation changes in respect of the investment income of foreign funds. Specifically, the government is seeking to:

  - prevent the Australian Taxation Office (ATO) from raising assessments for certain investment income of foreign

managed funds for the 2010-11 income year and previous income years to address a key area of investment uncertainty for fund managers investing in Australia

- change the tax treatment of certain investment income of foreign funds where those funds are taken to have a permanent establishment (PE) in Australia by virtue of the fact they have engaged an Australian-based intermediary. This measure provides an exemption from Australian income taxation where the fund uses an Australian-based investment manager to habitually negotiate and conclude trades (thereby creating an Australian PE). The exemption only applies to foreign-sourced income of the fund and not Australian-sourced income.

Taxation rulings

On 10 August 2011, the Commissioner of Taxation issued a Draft Addendum to GSTR 2006/10 ("GSTR 2006/10DA") regarding insurance settlements and entitlements to input tax credits. GSTR 2006/10DA amends the ATO's earlier opinion as to the operation of the Australian GST law in this regard following the Full Federal Court's majority decision in *Commissioner of Taxation v. Secretary to the Department of Transport (Victoria) 2010 FCAFC 84 ("DoT case"),* and the refusal by the High Court of Australia to grant the ATO special leave to appeal.

One of the outcomes of the DoT case was that it affirmed that one activity may give rise to two or more supplies. The court held that whether or not there are multiple supplies is to be determined from the perspective of the entity making the supply. In the context of insurance, this recognises that a supplier (e.g. a panel beater) may be supplying two services – one to the insured and the second to the insurer. Where there is a taxable supply to the insurer, the insurer may be entitled to claim input tax credits on payments it makes to the supplier.

The purpose of GSTR 2006/10DA is therefore to set out the Commissioner's view as to when it will accept that there is a supply to an insurer. It will accept that there may be a supply to the insurer provided that a 'pre-existing framework or agreement' can be established between the insurer and the supplier that is not merely a payment arrangement. Whether this condition is met is considered with regard to all the facts and circumstances.

GSTR 2006/10DA was open for comment until 16 September 2011.

The ATO released Taxation Determination 2011/21 ("TD 2011/21") on 17 August 2011, outlining its views relating to the capital/revenue distinction as it applies to trusts.

Broadly, TD 2011/21 states that in determining the character of income derived by trusts from investment activities, it is important to consider the specific circumstances of the trust, its establishment and the nature/purpose of the actual investment activities undertaken. It does not merely follow from the fact that an investment has been made by a trustee that any gain or loss from the investment will be on capital account for Australian tax purposes.

TD 2011/21 applies to years of income commencing both before and after the date of issue.

The ATO released draft Taxation Ruling 2011/D4 ("TR 2011/D4") on 24 August 2011, which focuses on whether a number of rights and obligations are themselves a single arrangement or two or more arrangements for the purposes of the TOFA regime.

Identifying an 'arrangement' is relevant for the purposes of determining whether there is a 'financial arrangement' under the TOFA regime. A 'financial arrangement' is the unit of taxation for the purposes of applying the TOFA regime.

TR 2011/D4 draws out some broad principles in determining whether rights and obligations form a single arrangement or multiple arrangements. In particular, TR 2011/D4 indicates that the identification of a financial arrangement or arrangements is not merely dependent on its legal form.

TR 2011/D4 is also helpful as it provides a number of examples seeking to illustrate whether a number of rights and obligations give rise to one or more arrangements. This could be important for the purposes of determining the timing recognition of particular TOFA gains and losses. For example, whether a facility agreement gives rise to a single arrangement or more than one arrangement could impact the timing recognition of borrowing costs under the compounding accruals TOFA methodology for Australian tax purposes.

Examples considered include a convertible note, loan and swap hedge, synthetic forward index-linked bond, facility agreements under various circumstances and multi-option facility agreements.

Other developments

On 31 August 2011, the ATO released the Technical Discussion Paper 2011/1 *Securitisation and TOFA ("*Technical Discussion Paper") for public consultation, addressing the application of the TOFA regime to a securitisation transaction.

In particular, members of a tax working group supplied the ATO with certain sanitised documents in relation to a bank-originated securitisation transaction involving a bank originator and a special purpose entity trust as the securitisation vehicle. The paper discusses this transaction in the context of the application of the TOFA regime.

The Technical Discussion Paper, whilst dealing with a very specific and complex securitisation transaction, is useful for understanding the current preliminary ATO view in relation to the application of various aspects of the TOFA regime in the context of securitisation transactions.

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Tax update

Clarification of corporate income tax treatment of interest and capital gains from treasury bonds

The State Administration of Taxation (SAT) issued Announcement [2011] No. 36 ("Announcement 36") on 22 June 2011 to clarify the corporate income tax (CIT) treatment of interest and capital gains derived from the holding or transfer of national debts. Announcement 36 is effective retrospectively from 1 January 2011.

Announcement 36 explains how interest and gains in connection with treasury bonds should be identified and calculated. The rules on the CIT treatment in Announcement 36 are consistent with the general principles in the CIT Law that interest derived from the holding of treasury bonds will be exempt from CIT, and capital gains derived from the redemption or transfer of the treasury bonds will be taxable. Therefore, the deduction of interest accruing during the holding period in the calculation of the gain from the redemption or transfer of treasury bonds is logical and reasonable.

For further information on Announcement 36, please refer to Issue 5 of *China Alert: Financial Service Focus*. A link to this publication is provided below:

http://kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-alert-Financial-Service-Focus/Pages/china-alert-FS-1107-05-corporate-income-tax.aspx

New guidelines for PRC securities companies to expand into direct investment and private equity business

The China Securities Regulatory Commission (CSRC) released Supervision Guidelines for Direct Investments by Securities Companies ("Formal Guidelines") on 8 July 2011, formalising the regulatory framework to allow all securities companies to incorporate direct investment into their regular businesses. In addition, securities companies will be permitted to set up private equity funds (through wholly-owned direct investment subsidiaries) to raise capital from third party institutional investors.

Under the previous pilot trial scheme introduced in 2007, securities companies meeting specific criteria were permitted to invest directly in non-listed companies seeking to launch an initial public offering (IPO). In May 2009, the CSRC released Trial Guidelines for Direct Investments by Securities Companies ("Trial Guidelines") and further relaxed its requirements to allow more securities companies to partake in the pilot trial scheme.

Overall, the Formal Guidelines have 'lowered the bar' for qualifying securities companies to undertake direct investments. At the same time, the Formal Guidelines prohibit securities companies from investing in pre-IPO companies for which they also act as the sponsor or advisor, thereby preventing perceived conflicts of interest and possible malpractice.

For further information on Formal Guidelines, please refer to Issue 6 of *China Alert: Financial Service Focus*. A link to this publication is provided below:

http://kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-alert-Financial-Service-Focus/Pages/china-alert-FS-1107-06-PRC-securities.aspx

China regulates cross-border reinsurance business settled in Renminbi

The China Insurance Regulatory Commission (CIRC) issued its notice concerning various issues with regard to cross-border reinsurance business settled in Renminbi (RMB) by way of circular Bao Jian Fa [2011] No.49 ("Notice 49"), setting out the requirements and guidelines for insurance companies in China in respect of their cross-border reinsurance business with RMB settlement. Notice 49 further lays the foundation for the said type of reinsurance business, which has been dealt with by the CIRC on a case-by-case basis since May 2010.

Notice 49 sets out specific guidance on the prerequisites of launching cross-border reinsurance business to be settled in RMB, the scope of permissible reinsurance business, requirements on the proportion of cession and CIRC filing procedures for insurers wishing to undertake such business.

Notice 49 is aligned with the overall strategy of the Chinese Government to accelerate the internationalisation of the RMB. The RMB settlement of cross-border reinsurance business will not only serve to accelerate the internationalisation of the RMB and the growth of cross-border service trade, but will also aid the development of the insurance industry as a whole.

For further information on Notice 49, please refer to Issue 7 of *China Alert: Financial Service Focus*. A link to this publication is provided below:

http://kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/China-alert-Financial-Service-Focus/Pages/china-alert-FS-1109-07-Reinsurance.aspx

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Tax update

Unrealised gains arising from revaluing unsold listed securities are not taxable – *Nice Cheer Investment Ltd v. CIR (2011) HCIA2/2007*

The Court of First Instance (CFI) stated in *Nice Cheer Investment Ltd v. CIR (2011) HCIA2/2007* that unrealised profits on listed securities are not 'assessable profits' and gains would only be taxable on realisation of the listed securities.

The taxpayer is a private company incorporated in Hong Kong and its principal business activity is investment trading. Trading securities are stated at fair value in the company's accounts at the balance sheet date. At each balance sheet date, the net unrealised gains or losses arising from the changes in fair value of trading securities are recognised in the income statement. Profits or losses on disposal of trading securities, representing the difference between the net sales proceeds and the carrying amounts, are recognised in the income statement as they arise.

The assessor was of the view that the unrealised gains and losses arising from revaluing the unsold listed securities held at the year end should be included in the profits tax computation for that year of assessment.

The CFI held against the Commissioner of Inland Revenue (CIR) after analysing the meanings of 'profits' and 'assessable profits' by reference to case law. On their true and proper construction, the terms 'profits' and 'assessable profits' mean real profits arising out of actual trading, and professional or business activities between the taxpayer and another party in Hong Kong. In the case of a taxpayer carrying out a trade, the trading activity means the buying or selling of commodities (including listed securities) or the provision of services in a commercial transaction for reward. The profits to be chargeable to profits tax must be real profits, in the sense that they have been earned, ascertained or accrued, regardless of whether they have been received in cash; but do not include book or notional profits arising out of revaluation of trading stock.

The decision is important and has far-ranging effects on the taxation of companies as the CFI's decision was contrary to the Inland Revenue Department's (IRD) practice as stated in DIPN 42 to tax unrealised profits/gains. Despite deciding that unrealised profits/gains are not assessable profits, the CFI confirmed that an 'unrealised loss' on listed securities could be allowed as a deduction.

The CIR has appealed against the decision, with the appeal scheduled to be held in May 2012.

For further details, please refer to the case at the link below:

http://legalref.judiciary.gov.hk/lrs/common/ju/ju_frame.jsp?DIS=77072&currpage=T

The IRD has changed its assessing practice for defined benefit schemes

The IRD has changed its assessing treatment for defined benefit schemes following its recent review and the legal advice recently sought on this issue. The IRD has concluded that any component forming part of the net total recognised in the profit and loss account or statement of comprehensive income is not deductible or assessable. Instead, the ordinary annual contributions paid are allowable under Section 16(1) of the Inland Revenue Ordinance (IRO) subject to the 15 percent limitation prescribed in Section 17(1)(h) of the IRO. For companies affected by the change of assessing practice, the company may include a computation of the overall effect of the change for earlier tax years in the 2010/11 tax computation, and the IRD has indicated that they would consider allowing a deduction for that amount in the year 2010/11.

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Tax update

An authorised dealer is not liable to withhold tax while making a remittance to a non-resident on account of sale proceeds representing short-term capital gains

The Mumbai Income Tax Appellate Tribunal ("the Tribunal") in the case of *Abu Dhabi Commercial Bank (the taxpayer) v. ITO [ITA No. 6749/Mum/2006 (AY 2006-07)]* held that the taxpayer acting as an authorised dealer was not liable to deduct tax at the source and was not a defaulter under the provisions of the Income Tax Act, 1961 ("the Act"), and is not liable to pay interest.

The taxpayer was engaged in banking business. The taxpayer made remittances during the year on account of short-term capital gains accruing to residents of the UAE without deduction of tax at the source. The remittances were made on the basis of certificates issued by the Chartered Accountants. The certificates stated that the capital gains tax was payable in the country of residence as per the India-UAE tax treaty, and therefore the taxpayer was not liable to deduct tax at the source.

The Assessing Officer (AO) observed that residents of the UAE were not eligible for exemption under the tax treaty. Therefore, he issued a show-cause notice calling upon the bank to explain why it should not be treated as a defaulter under the provisions of the Act in respect of obligations to deduct tax at the source before making the overseas payment.

The taxpayer contended that it was not responsible for paying tax under the provisions of the Act. Therefore, the taxpayer was not liable to deduct tax at the source under the provisions of the Act. The taxpayer further relied on the decision in the case of *Hongkong & Shanghai Banking Corporation Ltd*, which contended that the entity in the said case merely acted as an authorised dealer to transfer funds, and therefore it was not liable to deduct tax at the source.

On appeal to the Commissioner of Income Tax (Appeals) (CIT(A)), the CIT(A), relying on the decision in the case of *Green Emirates Shipping,* held that the taxpayer was not liable to deduct tax at the source under the provisions of the Act.

On appeal by the Tax department and cross objection by the taxpayer, the Tribunal held that the capital gains of the non-residents were short-term capital gains and the taxpayer, who was acting as an authorised dealer, was not liable to deduct tax at the source under the provisions of the Act. Accordingly, the Tribunal held that the taxpayer was not a defaulter and not liable to pay interest under the provisions of the Act.

A non-resident is not entitled to the concessional rate of 10 percent on capital gains

In the case of *Cairn UK Holdings Ltd (Applicant) [A.A.R. No.950 of 2010]*, the Authority for Advance Rulings (AAR) ruled on the issue of whether a non-resident is taxable in India at the concessional rate of 10 percent in respect of long-term capital gains arising from the sale of shares of an Indian company off–market. On interpretation of the provisions of the Act, the AAR held that the proviso to Section 112[1] does not apply to non-resident taxpayers who are eligible to claim benefits of foreign exchange fluctuations under the computation of the provision of capital gains under the Act. Accordingly, the applicant is not entitled to claim the benefit of the concessional rate of 10 percent under the proviso to Section 112 of the Act.

The applicant, a company based in Scotland, sold shares in Cairn India Limited to an Indian company off-market. The shares transferred were held for more than 12 months, and consequently were treated as a long-term capital asset. The assessee filed an application for advance ruling, claiming that it was entitled to the benefit of the proviso to Section 112 and was liable to pay tax at 10 percent of the capital gains. The Revenue denied the application on the grounds that the benefit of the

[1] The proviso to Section 112 provides that tax on capital gains derived from the transfer of listed securities/units/zero coupon bonds would not exceed 10 percent of the capital gains computed before giving benefit of indexation in terms of the second proviso of section 48 of the Act.

proviso to Section 112 was available only to assessees who were eligible for the benefit of indexation in the second proviso to Section 48[2]. As the assessee was not eligible for indexation, it could not claim the benefit of the lower rate of tax in the proviso to Section 112.

The AAR held that the application of the proviso to Section 112 is based on capital assets (being securities, units and zero coupon bonds) to which the provisions of the second proviso to Section 48 apply, and they do not apply to taxpayers who are not entitled to benefit from the Cost Inflation Index (CII). The non-residents who are given protection against inflation in respect of shares/debentures of an Indian company and who are kept out of the CII benefit in respect of such assets are not eligible for the 10 percent benefit under Section 112 of the Act.

Losses accruing to Foreign Institutional Investors on account of a cancellation of a foreign exchange forward contract having a direct nexus with an investment are capital losses which can be set off against long-term capital gains on shares

The Mumbai bench of the Tribunal in the case of *Citicorp Banking Corporation, Bahrain (the taxpayer) v. ADIT [2011-TII-40-ITAT-MUM-INTL]* held that losses accruing to Foreign Institutional Investors (FIIs) on account of the cancellation of a foreign exchange forward contract (exchange contract) having a direct nexus with an investment are capital losses which can be set off against long-term capital gains on shares.

The taxpayer, a foreign company, was registered as an FII with the Securities and Exchange Board of India (SEBI). Further, the taxpayer is a branch of Citicorp Banking Corporation, Bahrain and is a tax resident of the US.

The taxpayer earned a long-term capital gain on the sale of shares. Against this gain, the taxpayer set off a net loss which arose from the cancellation of an exchange contract. Accordingly, the taxpayer offered the net long-term-capital gain for taxation at 10 percent, as per the provisions of section 115AD[3] of the Act.

The AO held that an exchange contract cannot be considered as a capital asset, and the gain or loss that accrues from an exchange contract cannot be considered for taxation under Section 115AD of the Act. Therefore, the AO declined to give the benefit of the set-off in respect of the loss on cancellation of the exchange contract against long-term capital gains.

On appeal, the CIT(A) upheld the order of the AO; accordingly, the taxpayer approached the Tribunal.

The taxpayer contended before the Tribunal that as per the exchange control regulations, FIIs are allowed to hedge capital investments in India. The foreign exchange contract is restricted to the extent of the investment made by the FII. Further, the purpose for which the contract was entered into determined whether the contract was a capital asset or a trading asset. The exchange contract was entered into in order to protect against the risk of depreciation in the value of currency in which the capital asset is held, and hence the only purpose of entering into the exchange contract was for capital account.

The Tribunal observed that the dominant purpose for entering into the foreign exchange forward contract was to hedge against the depreciation of the foreign currency, and that it has direct nexus with the investments made. It is also a known fact that the taxpayer is not doing any business in India and is only engaged in the investment.

Accordingly, the Tribunal held that the loss accrued/arising on account of the cancellation of the exchange contract was a capital loss with a direct nexus with the investment of the taxpayer, and hence the taxpayer is entitled to set off the same. Section 115AD of the Act decides the quantum of the tax payable by the FIIs on the income from securities or capital gains and it has nothing to do with the determination of the nature of gain or loss. It does not take into account whether the loss/gain is on account of capital or revenue.

A company cannot be held to be a representative assessee for income earned by non-resident shareholders on account of the transfer of shares in the first mentioned company

In the case of *General Electric Company [W. P. No. 9100 of 2007(Delhi)]*, the Delhi High Court held that a company cannot be held as a representative assessee for income earned by non-resident shareholders on account of the transfer of shares in the first mentioned company. The taxpayer, a US-based company, owned a wholly-owned subsidiary (WOS) in Mauritius, which in turn owned a WOS in India. The shares held in the Indian subsidiary were transferred by the Mauritius company to another company in Luxembourg.

The tax authorities sought to tax the US company in India, contending that control of the Indian WOS had been transferred. For this purpose, the tax authorities treated the Indian WOS as the agent and representative assessee of the US company, and sought to recover tax from the Indian WOS.

In a writ application, the Delhi High Court, inter alia, held that the Indian WOS could not be treated as an agent of the foreign taxpayer merely because the shares of the Indian WOS were transferred. The High Court further held that:

- some sort of connection between the income earned by the US company and the Indian WOS needs to be established before the income is taxed in the hands of the Indian WOS as a representative assessee

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[2] The second proviso to Section 48 grants a benefit of indexation, i.e. the cost inflation index, when determining taxable capital gains.

[3] Section 115AD provides special tax treatment for FIIs under the Income Tax Act, 1961.

- there was no 'live link' between the income of the US company and the Indian WOS, and as the Indian WOS had 'no role' in the transfer, except that its shares were transferred, it could not be treated as the representative assessee of the US company in relation to the shares transferred.

However, the Delhi High Court has not dealt with the issue of the taxability of the shares transferred in the hands of the US company in India.

Bill discounting charges cannot be treated as 'interest' under Article 11 of the India-US tax treaty

The applicant, *ABC International Inc. [2011-TII-12-ARA-INTL]*, a tax resident of the US, is engaged in providing financial services. The applicant proposes to purchase and discount bills of exchange/promissory notes drawn by an Indian group company upon its customer on a 'without recourse' basis.

In the above context, the AAR, inter alia, analysed whether the income arising from discounting the bills of exchange or promissory notes is chargeable to tax in India. The AAR held that:

- for charging income under the head 'interest', a debt claim needs to exist
- discounting a bill of exchange or promissory note amounts to a purchase of the negotiable instrument, and it does not involve the creation of any debtor-creditor relationship between the endorser and the endorsee of the bill/note
- the endorsement of a bill of exchange/promissory note does not result in an assignment of the original debt
- accordingly, the discounting charges cannot be treated as 'interest' within the meaning of Article 11 of the India-US tax treaty.

The AAR further observed that the promissory note was payable in India, and upon discounting, the legal right to receive the proceeds accrues to the applicant in India. Therefore, the income in the hands of the applicant accrues in India as business income. However, in the absence of the applicant having a permanent establishment in India, such discounting charges are not taxable as business income in India.

A similar conclusion was reached by the High Court of Delhi in the case of *CIT v. Cargill Global Trading Private Limited*, where it was held that the discounting charges paid were not interest expenses in respect of a debt incurred or money borrowed, and hence could not be taxed in India as interest income.

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Tax update

Ministry of Finance Regulation No. PMK 85/PMK.03/2011 on the withholding, payment and reporting of income tax on interest from bonds

The Minister of Finance has issued a regulation governing the withholding, payment and reporting of income tax on interest from bonds. PMK 85/PMK.03/2011 revokes PMK 121/PMK.03/2002 that governs similar procedures.

There are some notable changes introduced through the new regulation including:

- The seller is now required to furnish the withholding agent with the withholding tax slip at the time of initial purchase to evidence the acquisition date and price.
- The acquisition date and price of the bonds to be sold are determined using a First In, First Out (FIFO) allocation method.
- The requirement to provide the withholding agent with the information of the acquisition date and price also applies to sellers not subject to withholding tax (i.e. banks and pension funds).

The requirement to provide the acquisition date and price by furnishing the withholding agent with the withholding tax slip may require additional document handling, but should be manageable. However, the requirement to apply a FIFO method of bond allocation may create some issues for companies who apply a manual allocation in determining which bonds to sell.

Japan

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Tax update

Temporary relief for investment income on listed shares

Extension of reduced withholding tax rates on dividends

The reduced withholding tax rates on dividends from listed shares will be extended as follows:

Where resident individuals receive dividends

Before amendment

Until 31 December 2011	From 1 January 2012
Reduced tax rates National tax 7%, Local tax 3%	Standard tax rates National tax 15%, Local tax 5%

After amendment

Until 31 December 2013	From 1 January 2014
Reduced tax rates National tax 7%, Local tax 3%	Standard tax rates National tax 15%, Local tax 5%

Where Japanese companies/foreign companies/non-resident individuals receive dividends

Before amendment

Until 31 December 2011	From 1 January 2012
Reduced tax rates National tax 7%	Standard tax rates National tax 15%

After amendment

Until 31 December 2013	From 1 January 2014
Reduced tax rates National tax 7%	Standard tax rates National tax 15%

Reduction in the threshold of major individual shareholders who are not eligible for reduced tax rates on dividends

The definition of individual shareholders who are not eligible for the reduced tax rates and reduced withholding tax rates on dividends from listed shares was amended to those who hold 3 percent or more of the outstanding shares (5 percent before amendment).

Interest on book-entry bonds/repo transactions

Interest on book-entry bonds

Before the amendment outlined below, interest and profits from the redemption of book-entry bonds (Japanese Government Bonds [JGBs], Japanese Local Government Bonds [JLGBs] and corporate bonds) received by non-resident individuals or foreign companies were tax exempt under certain conditions. This exemption regime was amended as follows.

Beneficial interests in book-entry special purpose trusts

Gains on redemption of quasi-bond beneficial interests in book-entry special purpose trusts (provided the interests have voting rights only with respect to important matters) and profit distributions paid in respect of such interests will be included in the scope of the aforementioned exemption regime upon the amendments to the Asset Liquidation Law. The main purpose behind this amendment is to establish viable Shariah-compliant financing structures in Japan.

This change will be applied to distributions whose calculation periods commence on or after the date of enforcement of the amended Asset Liquidation Law.

This amendment has been made in a bill to amend the Financial Instruments and Exchange Law and its related laws (including the Asset Liquidation Law and Special Taxation Measures Law) approved by the Diet on 17 May 2011, not in the new bill for the 2011 tax reform. Although the amended laws were promulgated on 25 May 2011, as this amendment will be enacted within six months from the promulgation, the details of the amendment need to be confirmed in the cabinet orders/ministerial ordinances to be released in the near future.

Foreign pension trusts

The exemption regime will apply to interest on book-entry bonds that are the trust property of a foreign pension trust (as described below), with the trustees of the foreign pension trust being treated as the recipients of such interest.

A foreign pension trust is a trust established in accordance with foreign law which resembles a Japanese retirement pension trust (limited to beneficiary-taxed trusts) and is involved primarily in the management and administration of benefits for retirement pensions within that foreign jurisdiction.

This change will be applied to interest on book-entry bonds with interest calculation periods commencing on or after 30 June 2011.

Partnerships/Beneficiary taxed trusts

Interest on book-entry bonds held either as partnership property of a partnership (Nin'i Kumiai or other such similar domestic/foreign partnerships) or in trust by a beneficiary-taxed trust (excluding foreign pension trusts) and received by a non-resident individual or foreign company will fall within the scope of the exemption regime, provided the following measures are taken in addition to the normal procedures required to obtain an exemption:

- Submission of the following documents by the partnership operating officer:
  - documents providing the name/address of the partnership, name/address of the operating officer and name/address/profit distribution ratio of each partner
  - a copy of the partnership agreement
  - a statement of the holding period of the interest by each partner.
- Submission of the following documents by the trustee of the beneficiary-taxed trust:
  - documents providing the name/address of the trust, name/address of the trustee and name/address/profit distribution ratio of each beneficiary
  - a copy of the trust agreement
  - a statement of the holding period of the interest by each beneficiary.

This change will be applied to interest on book-entry bonds with interest calculation periods commencing on or after 30 June 2011.

Repo transactions

Before the amendment outlined below, interest paid to foreign financial institutions in respect of certain bond gensaki repo transactions was tax exempt. This exemption regime was amended to apply to other repo transactions as follows:

Scope of tax-exempt income

The scope of the exemption regime will be expanded to include interest and lending fees arising from securities lending transactions which satisfy certain conditions (e.g. having a transaction period which does not exceed six months) and for which cash or securities are put up as collateral.

Scope of bonds covered by the exemption regime

The scope of bonds covered by the exemption regime (e.g. book-entry JGBs, bonds issued by foreign companies) will be expanded to include the following:

i. book-entry JLGBs

ii. book-entry corporate bonds

iii. quasi-bond beneficial interests in book-entry special purpose trusts (provided the interests have voting rights only with respect to important matters)

iv. listed shares (limited to shares used in securities lending transactions and not gensaki transactions).

(For (ii) and (iii) above, profit-linked interest and lending fees are excluded from the exemption.)

In principle, this change will be applied to the interest and lending fees arising from bond gensaki transactions and securities lending transactions commencing on or after 30 June 2011.

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Bank levy

The Korean Government has commenced imposing a levy on banks' non-depository foreign borrowing to prevent excessive capital flows from hurting the nation's financial and economic stability.

The Ministry of Strategy and Finance (MOSF) published the final version of the Presidential Decree of Foreign Exchange Transactions Act with regard to the bank levy on 25 July 2011. The bank levy took effect from 1 August 2011. Thirteen local banks, 37 branches of foreign banks and state banks such as the Korea Development Bank, Export-Import Bank of Korea, Industrial Bank of Korea, Korea Finance Corporation, Nonghyup Bank and National Federation of Fisheries Cooperatives are subject to the new levy.

The bank levy rate will differ according to the maturity of non-depository foreign borrowings as follows:

- For short-term non-deposit borrowings with a maturity of less than one year: 0.2 percent
- For borrowings with a maturity of one to three years: 0.1 percent
- For borrowings with a maturity of three to five years: 0.05 percent
- For borrowings with a maturity of more than five years: 0.02 percent.

However, regional domestic banks with head offices located outside the metropolitan area in Korea will be subject to the bank levy at a 50 per cent reduced rate on foreign currency liabilities.

MOSF will issue the assessment within four months after the end of the fiscal year and the levy payer should file and pay the assessed amount within five months after the end of the fiscal year. The payment will be permitted in three instalments in a given year for reasons such as financial difficulties.

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Exchange of information with foreign competent authorities

Based on the release of the Income Tax (Exchange of Information) Rules 2011, a foreign competent authority may now request information of a person from the Director General of Inland Revenue (DGIR) if its government has entered into a double taxation agreement with the Malaysian Government.

Where the DGIR fails to obtain information from any person, they may ask a bank or finance company to provide the information requested by the foreign competent authority. The request for information from a bank or finance company shall be subject to the approval of the Central Bank of Malaysia.

The above rules are effective from 2 July 2011.

New Zealand

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Foreign investment portfolio investment entities

Legislation has been enacted to remove the current tax disadvantages for non-residents investing through New Zealand-managed funds.

Under the changes to New Zealand's portfolio investment entity (PIE) tax regime, non-resident investors in New Zealand-managed funds that become foreign investment PIEs, will not be taxed on their foreign-sourced income through the PIEs.

If a foreign investment PIE invests in New Zealand assets (e.g. shares and debts), income from these investments will be taxed at tax rates comparable to those that would be applicable if the non-resident had invested directly (e.g. New Zealand dividends and New Zealand-sourced interest are generally taxed at 15 percent and 10 percent respectively under double tax agreements, with the latter reduced to 2 percent under the Approved Issuer Levy for direct investment).

The changes are part of the government's wider objective to promote New Zealand as an Asia Pacific hub for managed funds, with a particular emphasis on fund administration services.

New Zealand Labour Party announces its tax policy for the 2011 general election

In July, the main opposition Labour Party released its key tax policies to be contested in November's general election. The proposals include:

- a 15 percent capital gains tax (CGT), subject to certain exclusions (e.g. the family home, certain small business assets and personal assets)
- a new top marginal tax rate of 39 percent on income above NZ$150,000 and an income-free threshold of NZ$5,000
- a 12.5 percent tax credit for research and development expenditure
- changes to the New Zealand goods and services tax (GST) system to 'zero rate' fresh fruit and vegetables.

The Labour Party's proposed CGT will apply to financial assets such as investments in shares, and will also apply to investments by individuals, companies, managed funds and other financial institutions. However, the CGT is aimed primarily at New Zealanders' investments in residential rental properties and farm assets.

The current government has indicated that it is against the introduction of a CGT, changes to the GST regime and increasing the top marginal tax rate. The current government's election policies are yet to be announced.

Tax avoidance landscape

In a recent decision on the application of the New Zealand tax anti-avoidance legislation, *Penny and Hooper v. CIR [2011] NZSC 95*, the New Zealand Supreme Court has confirmed the importance of the "Parliamentary Contemplation" test (i.e. whether the arrangement entered into is structured to utilise the tax rules in a way that is outside the legislation's intent) and the nature of the tax benefits (i.e. whether they are incidental to, or overwhelm, the commercial drivers of the transaction) in the tax avoidance analysis.

The above finding is consistent with the decision in the recent Bank of New Zealand and Westpac Conduit Financing tax avoidance cases, which were also decided in favour of the New Zealand Inland Revenue (albeit in the lower courts, with the defendants electing to settle rather than appeal). The previous development of the case was included in our Issue 35, which can be accessed via the link below for further details:

http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/General-Tax-Update/Documents/General-tax-update-1004-35.pdf

Gift duty repeal

Legislation repealing duty on the gifting of money and property (i.e. "gift duty") from 1 October 2011 has been enacted.

Double tax agreement developments

The New Zealand Government announced in August that withholding tax rates:

- on dividends under the New Zealand–Mexico double tax agreement (DTA) have been reduced from 15 percent to 5 percent or zero (if certain criteria are met)
- on royalties under the New Zealand–Chile DTA have been reduced from 10 percent to 5 percent.

The reduced withholding rates apply retrospectively from 1 May 2010, and are as a result of the 'most favoured nation' clauses in the respective DTAs, which were triggered when lower withholding rates under the New Zealand–Australia DTA were negotiated last year.

A new DTA with Turkey has also been signed into force by both countries and will apply from 1 January 2012 at the earliest (e.g. for withholding taxes). The treaty, which was negotiated in 2009, was pending ratification.

GST cross-border neutrality

The government has released a consultation paper on options to reduce the cost of New Zealand GST for non-resident businesses that use New Zealand service providers.

The preferred option, which is an enhanced New Zealand GST registration scheme for non-resident businesses to make it easier for these businesses to claim GST inputs on their New Zealand costs, may be of benefit to foreign financial institutions that use New Zealand providers and make some 'taxable supplies' in New Zealand.

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Recent case law

The Supreme Court, in the case *Prudential Bank v. Commissioner of Internal Revenue (G.R. No. 180390, 27 July 2011)*, affirmed that:

- A Savings Account Plus (SAP) product or Savings Plus Deposit Account is subject to documentary stamp tax as it is essentially the same as the Special/Super Savings Deposit Account and the Savings Account-Fixed Savings Deposit of other banks, which are considered certificates of deposit earning interest.
- Although the money deposited in an SAP is payable anytime, the withdrawal of the money before the expiration of thirty days results in the reduction of the interest rate. In the same way, a time deposit withdrawn before its maturity results in a lower interest rate and payment of bank charges or penalties.
- The fact that the SAP is evidenced by a passbook cannot remove its coverage from Section 180 of the old Tax Code, as amended. For a document to be considered as a certificate of deposit, it need not be in a specific form. Thus, a passbook issued by a bank qualifies as a certificate of deposit earning interest because it is considered a written acknowledgement by a bank that it has accepted a deposit of a sum of money from a depositor.

Department Order – taxation of government securities

The Department of Finance issued *Department Order No. 020-10*, dated 15 June 2010, pursuant to Republic Act (R.A.) No. 245, as amended, and Republic Act (R.A.) No. 7653, to prescribe the omnibus revised rules and regulations on the issuance, placement, recording, selling, servicing, redemption and payment of government securities issued by the Philippine Government. The Department Order mandates that:

- Income derived from government securities issued pursuant to R.A. No. 245, as amended, shall be subject to the applicable final tax rate under the National Internal Revenue Code in force at the time of issue, and the rules and regulations issued by the Bureau of Internal Revenue. Discounts shall be valued at the time of issue on every original sale, and tax on the discount shall be included in the remittance of the purchase price. Periodic coupon payments on government securities shall be subject to the applicable final tax to be withheld at the time the coupon payments are made.
- Government securities issued pursuant to R.A. No. 1000 (broadly government bonds issued to finance public works and projects for economic development), as amended, shall not be subject to tax.
- The documentary stamp tax on the original issue of government securities under R.A. No. 245 shall be for the account of the issuer.
- No other taxes shall be collected on subsequent trading of the securities which have been subjected to tax under the first paragraph herein.
- The taxation of government securities transactions conducted under Securities and Exchange Commission-approved (SEC) borrowing and lending programmes of accredited government securities trading markets shall be governed by the rules, regulations and issuances of the Bureau of Internal Revenue.
- Repurchase agreements for government securities conducted under relevant SEC-approved programmes of accredited government securities trading markets and which provide for the transfer of title over government securities, shall be deemed to be covered by the exemption from documentary stamp tax under the relevant provisions of the Documentary Stamp Tax Law.

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Islamic financing

Under Section 43Q of the Income Tax Act, a concessionary tax rate of 5 percent is accorded to income derived by a Financial Sector Incentive–Islamic Finance (FSI-IF) company from prescribed Shariah-compliant activities in key areas of the finance sector, namely: (i) lending and related activities; and (ii) fund management and investment advisory services rendered in relation to funds.

In order to enjoy the 5 percent concessionary tax rate for lending and related activities, one of the requirements is for the qualifying Islamic activities to be structured according to one of six Shariah-compliant concepts, these being, Murabaha, Mudaraba, Ijara Wa Igtina,Musharaka, Istisna or Salam.

The Monetary Authority of Singapore (MAS) issued a circular on 8 June 2011 to further elaborate on the Murabaha concept. The circular also touches on the detailed workings of the following prescribed Islamic financing activities and the corresponding direct and indirect tax incentives that would apply to those qualifying prescribed Islamic transactions. The relevant transactions are Musharaka, Istisna and Wakalah.

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Further relaxation of exchange control regulations (with effect from 18 August 2011)

Following the exchange control relaxations proposed in the 2011 budget, permission has been granted for the issue and transfer of units in a unit trust operated on a licence issued under the Securities and Exchange Commission of Sri Lanka Act, to foreign institutional investors, corporate bodies incorporated outside Sri Lanka and individuals resident outside Sri Lanka (including Sri Lankans resident outside of Sri Lanka), subject to the following conditions:

- The foreign investor is required to make a declaration to the effect that they are a 'person resident outside Sri Lanka', on the application form for the purchase of units.
- The payment for the purchase of units should only be made out of or into a Securities Investment Account (SIA) opened with any licensed commercial bank in Sri Lanka.
- Payment of monies such as redemption proceeds, sale proceeds or commissions in respect of any such investment in units should only be made into or out of an SIA.
- A managing company or any other person who is entrusted with maintaining a register of unit holders or of the issue or transfer of units by any unit trust shall not register the names of investors falling within the aforesaid categories or their nominees as a 'holder of units' of such unit trust unless evidence is provided to the satisfaction of that person that the above terms and conditions have been complied with.

Taiwan

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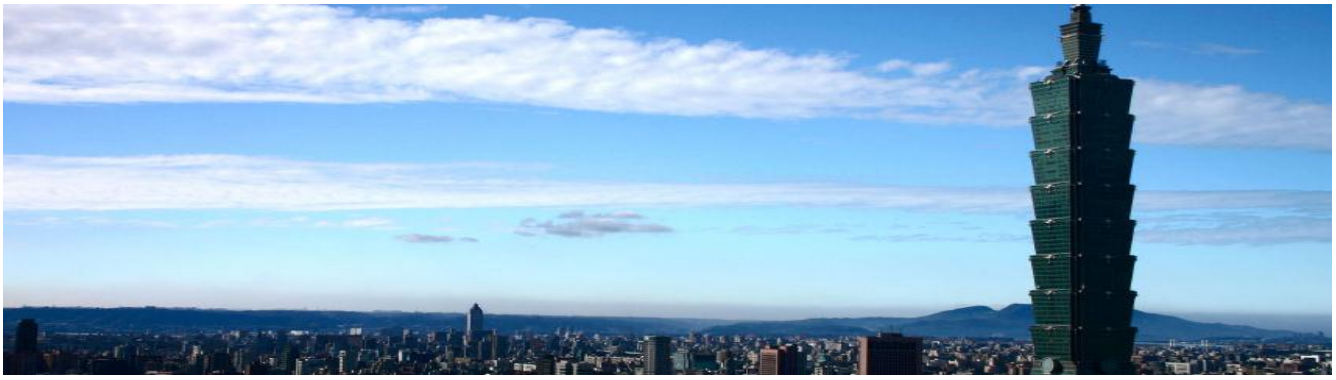

Tax update

Taiwan-India double taxation treaty

Taiwan has recently entered into a double taxation treaty with India. Given India is recognised as one of the largest emerging economies, the signing of this agreement will likely have a positive effect on the trading and investment activities between the two countries.

The Taiwan-India double taxation treaty (Taiwan-India DTA) was signed on 12 July 2011 and became effective as of 12 August 2011. The Taiwan-India DTA applies to income derived on or after 1 January 2012 in Taiwan, and on income derived in the fiscal year beginning on or after 1 April 2012 in India.

The Taiwan-India DTA provides for reduced withholding taxes on dividends, interest and royalties. The treatment allows for a reduction from the standard Taiwan withholding tax rate of 20 percent to the following reduced rates:

- dividends: 12.5 percent
- interest income: 10 percent
- royalty and technical service fees: 10 percent.

No pre-approval from the Tax authority is required for the adoption of the reduced withholding rates pursuant to the double taxation treaty.

Similar to the other recent double taxation treaties which Taiwan has entered into, such as the Taiwan-France tax treaty, the Taiwan-India double taxation treaty also has a specific anti-treaty shopping article. According to this article, the enjoyment of the treaty benefits will be denied if the applicant's main purpose or one of the applicant's main purposes is to utilise the treaty benefits. In light of this article, companies involved in cross-border transactions need to be mindful of the potential challenge from the tax authorities against aggressive tax planning structures.

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Official guidance issued on Resolution 08/2011/QH13 granting tax relief to businesses and individuals

The tax relief measures are as follows:

- From 1 August 2011 to 31 December 2012, an exemption from personal income tax (PIT) on dividends earned by individuals from investments in the securities market and from capital contributions to enterprises (except dividends from investments in joint stock banks, financial investment funds and credit institutions) has been granted.
- From 1 August 2011 to 31 December 2012, withholding PIT reduces from 0.1 percent to 0.05 percent on securities transfer activities by individuals.
- From 1 August 2011 to 31 December 2011, individuals with salaries, wages or business income (i.e. after deduction of tax relief) of less than VND 5 million a month are exempt from PIT.

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