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# Asia Newsletter

Summer 2008



# China (PRC)

## Deductions for sole traders, proprietorship enterprises and partnerships clarified

- The Ministry of Finance and State Administration of Taxation (SAT) jointly issued a Notice on 3 June 2008 (Cai Shui [2008] No. 65) clarifying the deductions for expenditure incurred for the purposes of a business by sole traders, sole proprietorship entrepreneurs and partners of a partnership. Unless otherwise indicated, the Notice applies from 1 January 2008.
  - sole traders, sole proprietorship entrepreneurs and partners of a partnership are entitled to a standard deduction of CNY 24,000 per annum (CNY 2,000 per month). This amount can be deducted from the taxable income regardless of actual expenditure and is applicable from 1 March 2008;
  - “reasonable” salaries or wages actually paid to the employees are deductible in computing profits;
  - contributions paid on trade union, welfare funds, employee educational funds are deductible up to a maximum of 2%, 14% and 2.5% respectively;
  - expenditure incurred in respect of advertisement and business promotions are deductible if they do not exceed 15% of the sale proceeds of the current year. Any excess can be carried over to the following years and claimed as a deduction; and
  - entertainment expenses are deductible up to 60% of the amount incurred but subject to a maximum limit of 0.5% of the current year sales proceeds.
- The Notice also states that the previous notice (Cai Shui [2006] No. 44) issued to regulate deductions for the same group taxpayers no longer applies.

## Resource tax reform delayed

- It was reported on 8 July 2008 that the Chinese government has delayed the launch of reform to the country’s resource tax regime because of inflation concerns. The State Council, China’s cabinet, had received a reform proposal but did not approve the plan because of concerns about its inflationary impact. The paper said the government may implement the reform plan in about three months. It is believed that the relatively low tax burden on miners under the current volume-based system undermines incentives to conduct mining in a responsible and sustainable manner. Increasing the resource tax would reportedly help eliminate small, heavily polluting mines and encourage larger, more efficient operations. The Ministry of Finance has said the tax would be levied by local governments to help raise local revenue.

## International tax developments

- Hong Kong. China signed a new Protocol to its Tax Arrangement with Hong Kong on 30 January 2008 in Beijing, which amends the 2006 Hong Kong-P.R.C. Tax Arrangement. The Protocol deals with a host of important matters such as the “subject to tax”, “PE number of days presence in China” and when a company classifies as a real property owning company.

# Hong Kong

## Import processing source of income

- It was reported on 9 July 2008 that the Hong Kong Court of First Instance ruled that profits derived by a Hong Kong taxpayer from the sale of goods manufactured by its mainland subsidiary under an import processing arrangement can be apportioned on a fifty-fifty basis in favour of the taxpayer.

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The information below is produced by Loyens & Loeff in Singapore and Tokyo. It is designed to alert those (interested in) doing business in the Asian region to recent developments in the region. Such developments are discussed in brief terms and are based on generally available information. The materials contained in this publication should not be regarded as a substitute for appropriate detailed professional advice. The information below was assembled based on information available as at 30 June 2008.

- The Hong Kong Court of First Instance, in *Commissioner of Inland Revenue v. Datatronic Ltd.* (decided 13 June), has ruled that profits derived by a Hong Kong taxpayer from the sale of goods manufactured by its mainland subsidiary under an import processing arrangement can be apportioned on a fifty-fifty basis in favour of the taxpayer.
- The fifty-fifty apportionment is a concession granted by the Hong Kong Inland Revenue Department (IRD) in Departmental Interpretation and Practice Notes 21 (DIPN 21) issued in March 1998, which sets out the IRD's position on the source of various types of income.
- The court's decision conflicts with the IRD's current practice, which is to grant the fifty-fifty apportionment only to contract processing arrangements. According to the IRD, import processing arrangements do not qualify for apportionment; instead, profits derived from such arrangements should be taxed as trading profits and taxed in full.
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- Contract processing is when a non-Mainland entity enters into a processing agreement with a Mainland factory under which the non-Mainland entity supplies raw materials to the Mainland factory for processing. The processed goods must be delivered back to the non-Mainland entity for onward export sales; the Mainland factory does not own the raw materials and finished goods -- in other words, the title of raw materials does not change during the entire manufacturing process. The finished goods have to be exported and sold outside the Mainland. In addition to the provision of raw materials, the non-Mainland entity also provides machinery, designs, and technical support, and manages and supervises the factory workers. The Mainland factory provides the land, building, and labour. The non-Mainland entity typically is a Hong Kong entity. In recent years, a growing number of contract processing arrangements have been converted into import processing arrangements. Under an import processing arrangement, the mainland factory purchases raw materials from the non-Mainland (Hong Kong) entity and sells the finished goods it manufactures to the non-Mainland (Hong Kong) entity on its own account.
- Hong Kong's taxation system is territorial based, so only profits arising in or derived from Hong Kong are subject to profits tax in Hong Kong. Offshore income is generally not subject to Hong Kong tax. As noted above, DIPN 21 sets out the IRD's position on the source of various types of income. For manufacturing profits, the source is where the manufacturing operations take place. When a Hong Kong manufacturing business enters into a processing arrangement with a Mainland entity and the Hong Kong entity provides the raw materials, technical know-how, management, production skills, designs, skilled labor, training, and supervision for locally recruited labor, the IRD will generally allow the profits derived by the Hong Kong entity on the sale of the relevant manufactured goods to be apportioned and taxed on a fifty-fifty basis on the grounds that the sales activities are carried out in Hong Kong but the manufacturing activities are carried out outside of Hong Kong.
- In practice, however, the IRD restricts apportionment to situations in which the underlying arrangement is a contract processing arrangement. Profits derived from import processing arrangements are treated as trading profits (rather than manufactured profits) and are fully chargeable to tax. Under DIPN 21, apportionment is not allowed for trading profits.
- There has been a long debate about whether substance should prevail over form or vice versa for purposes of Hong Kong taxation. In *Datatronic*, the court adopted the former approach in concluding that the taxpayer had undertaken operations

in the Mainland that were important and attributable to the profits in question, and that those profits were sourced outside Hong Kong and thus not chargeable to tax, even though the form was that of an import processing arrangement. This approach contrasts with IRD practice, which often emphasizes the legal form rather than the substance of the transaction.

- It is believed by local tax practitioners that the Court of First Instance properly applied the operations test and stressed substance over form in the case. It is, however, uncertain whether that approach could apply to determine the nature of transactions and tax consequence of taxpayers in general.
- The case also raised an issue as to whether an apportionment should be on a fifty-fifty basis as set forth in paragraph 22 of DIPN 21. While the fifty-fifty basis is simple to apply under the IRD concession, depending on the extent of the taxpayer's operations in and outside Hong Kong, that basis may not be fair to the taxpayer or the IRD. Thus, a greater or smaller apportionment ratio may be more appropriate in some cases. However, taxpayers will have the arduous task of gathering facts and evidence to support their basis of apportionment.
- Taxpayers that have import processing arrangements and that have filed on a fully taxable basis in the past should review their position to see if they can take advantage of the Datatronic decision. Of course, taxpayers cannot assume that their manufacturing process in the form of import processing is the only factor for a fifty-fifty apportionment claim. The nature of the transactions, particularly the extent of the taxpayer's involvement, should be the major consideration in determining the nature of profits and the application of the apportionment of profits.
- The IRD is likely to appeal to the higher courts, so there is a risk that the decision of the Court of First Instance may be overturned. However, this case may temporarily serve as precedent for taxpayers with manufacturing processes carried out in the mainland under import processing arrangements to lodge an offshore claim. Those taxpayers should review their operations and consider lodging a fifty-fifty apportionment claim in their 2007-2008 tax return filings. If a taxpayer does not file an offshore claim now and the final outcome of Datatronic remains in Datatronic's favor, it probably will not be possible later to file revised returns for prior years and submit

the offshore claim, because the tax assessments would likely have become final and conclusive. It is, therefore, important that affected taxpayers seek immediate professional tax advice on their best supportable filing basis.

## Stock awards

- The Hong Kong Inland Revenue Department (HKIRD) issued, in March 2008, a revised edition of the Departmental Interpretation and Practice Notes No. 38 (DIPN 38) on Salaries Tax Employee Share-Based Benefit. The first and second editions of the DIPN were issued in February 2001 and March 2005 respectively. The March 2008 revised edition is to replace the earlier editions and takes effect immediately.
- DIPN 38 provides formal guidance on the tax treatment of stock plans and stock awards, and contains a new section on the assessability of stock award benefits (including a commentary on phantom stock plans), as well as an analysis of reporting and administration considerations. There are no changes to the commentary and practice on the tax treatment of stock options. The following are the key features of DIPN 38:
- DIPN 38 focuses on the point at which the employee is regarded as being fully entitled to the ownership of the shares, or when the employee is entitled to the full economic benefit of the shares. Two approaches have been outlined, i.e. the "upfront approach" and the "back-end approach" to highlight the complexity and variety of plans offered by the employers.
- The upfront approach deals with plans in which stock is awarded with restrictions, e.g. the employee is prohibited from selling the stock awarded within a certain period of time. However, within the restricted period, the employee has all the rights of a normal shareholder. Under this plan, the market value of shares at the time of the grant is subject to salaries tax and no subsequent tax is charge on dividends received or on capital growth (if any). As for the back-end approach, it deals with plans in which specific conditions have to be satisfied before the stock is vested in the employee, e.g. the employee is required to complete a period of employment with the same employer/group. Under this plan, salaries tax will be chargeable on market value of the stock at the date of vesting (i.e. the point at which rights to the stock pass to the employee).

- The HKIRD's view that the source of stock awards benefits would be determined in the same manner as that applicable to other perquisites. Hence, the days in Hong Kong in the year of assessment that vesting takes place would be taken into account. However, for share options benefits, HKIRD would take into account the days in Hong Kong during the whole vesting period.
- Shares vested after cessation of employment are deemed to accrue on the last day of employment.
- For non-Hong Kong employment, the taxable portion of the income is ascertained by time apportionment on a "days-in-days-out" basis. The following base criteria must be met to qualify for time apportionment, i.e. (i) the employer must be resident outside Hong Kong, (ii) the employment contract/Hong Kong assignment letter must have been negotiated, concluded and enforceable outside Hong Kong, and (iii) remuneration must be paid outside Hong Kong.
- Under DIPN 38, stock awards assessed using the back-end approach are taxed as perquisites accruing to the employee in the year of assessment in which vesting takes place. It also states that it is only necessary to apply the time apportionment factor by the reference to the "days-in-days-out" in the year of vesting.
- For inbound and outbound employees under the back-end approach, firstly the portion of the benefits attributable to their pre/post-Hong Kong assignment period is to be excluded, and subsequently the time-apportionment factor is to be taken into account in the year of vesting for inbound employees or in the year of departure for outbound employees.
- Where stock awards are assessed using the back-end approach and the employee concerned is leaving Hong Kong permanently, the HKIRD allows the employee to make an election for all unvested shares to be treated as vested at the time of departure from Hong Kong. Once the election is made and accepted by the HKIRD, the employee is not allowed to withdraw such election or seek to revise the assessment.
- DIPN 38 also provides guidance on "phantom" or "hypothetical" shares. Under these plans, employees receive a future cash bonus linked to the value of those shares. DIPN 38 indicates that no tax is chargeable when the phantom shares are allocated

if no actual value passes to the employee. When the cash bonus is received, it will be taxed together with the employee's other income in the year of payment.

## **Legislative Council of Hong Kong SAR passes Revenue Bill 2008**

- On 26 June 2008, the Hong Kong Legislative Council passed Revenue Bill 2008 to implement a number of the revenue measures announced in the Budget for 2008/09. The Hotel Accommodation Tax Ordinance (Cap.348) and the Inland Revenue Ordinance (Cap.12) will be amended to give effect to the relevant revenue proposals i.e. respectively:
  - the waiver of hotel accommodation tax (effective on 1 July 2008); and
  - the proposals relating to salaries tax, tax under assessment, profits tax and property tax (effective from the year of assessment 2008/2009 onwards).

## **Air transport treaties with Finland and Mexico**

- Three orders were gazetted on 20 June 2008, mainly to give effect to the double taxation relief arrangements relating to aircraft operations as agreed between the Government and Mexico and Finland. Under the double taxation relief arrangements, tax exemption for income and profits derived from aircraft operations in international traffic is provided for the airlines of Hong Kong, Mexico and Finland. Aircraft operators of Hong Kong, Mexico and Finland will benefit from the avoidance of double taxation.

# **India**

## **Project monitoring services rendered by foreign company with PE in India**

- The Indian Authority for Advance Rulings (AAR) delivered a ruling dated 30 April 2008 in the case of Worley Parsons Services Pty. Ltd on whether income from providing technical supervisory services would be taxable in India as "royalty" under the India-Australia tax treaty (the Tax Treaty) even when there is no

actual transfer of know how and the foreign entity had a permanent establishment in India. The Applicant's responsibilities included monitoring of the detailed project schedule, identifying of critical activities of the pipelines, and other similar activities falling within the critical path of the project. The Applicant argued that most of the services relating to the work assigned to it were performed in India, and in fact nearly 90% to 95% of the work related to the contract was performed in India. Further, employees of the Applicant were also present in India for a substantial period of time during the financial year.

- The key issue before the AAR was whether the income from the project monitoring services rendered to an Indian resident by an Australian consultant was in the nature of "royalties" as defined under Art. 12 of the Tax Treaty. If that is not the case, then should such receipts be treated as business income and if so, to what extent.
- The AAR ruled that the income attributable to the Applicant's PE would be charged to tax as business profits and not as royalty. The AAR held that the income received by the Applicant did not fulfil the definition of "royalty" as per the Tax Treaty since no technical knowledge, experience, skill or know-how was "made available" when the Applicant rendered such services. Also, the mere rendering of services did not result in technical knowledge, etc. being made available that would have resulted in the customer being able to subsequently use such information on its own.
- The AAR further observed that the Applicant's income from the contract with the Indian customer would not be taxed under the Income Tax Act 1961 as "fees for technical services" since that would be in derogation of the Tax Treaty. The income was chargeable under Art. 7(1) of the Tax Treaty as business profits to the extent that it could be attributed to the PE. This was based on the reasoning that firstly, most of the Applicant's work with respect to the contract was carried out in India (thus fulfilling Art. 5(k)) and secondly, the income not qualifying as royalty was not covered by any other provision of the Tax Treaty.

## Purchase office

- It was reported that the Income Tax Appellate Tribunal, Bangalore, has held that because a non-resident company's liaison office acted only as a buyer's agent for placing purchase orders on behalf of various affiliates, the liaison office could not be classified and taxed as a permanent establishment in India.

## Overseas companies considered taxable in India

- It was reported on 20 June 2008 that several TV companies and film production companies in Mumbai are under the watch of the Indian Income Tax Department for allegedly routing their business through companies set up in tax havens such as Mauritius, Cyprus, and Guernsey to avoid taxes payable in India.
- The Indian income tax authorities got an idea of the scale of such deals when TIFC Cyprus, an associate company of the Indian entity Network 18, applied for permission to pay UTV Mauritius, a group company of UTV India, for the worldwide rights of the Indian-language movie Welcome. In the application, TIFC Cyprus claimed it was not liable to pay withholding tax in India because the transaction was between two companies outside India.
- The Indian Income Tax Department held that TIFC Cyprus was liable to pay withholding tax in India even though the sale of the movie rights took place outside India between two companies registered outside India, because the business was carried out mostly in India. Profit also was generated in India, the tax authorities held. UTV Mauritius, which acquired the rights of Welcome at INR 4.8 million, had sold them to TIFC Cyprus for INR 5.2 million. Because UTV Mauritius had generated a profit through the sale, the Indian tax authorities held that it was liable to pay tax in India, and therefore TIFC Cyprus was liable to pay withholding tax in India.

## Transfer of brands and intellectual property by foreign company

- The Indian Authority for Advance Rulings (AAR) delivered a ruling dated 9 May 2008 in the case of Foster's Australia Limited (2008-TIOL-07-AAR) holding that income arising to a foreign company from the transfer of its:
  - right, title and interest in trademarks and intellectual property, was chargeable to capital gains tax in India, and
  - its tangible assets, which were not situated in India at the time of transfer, were not liable to tax in India.
- The Applicant (i.e. Foster's Australia Limited) was an Australian company, engaged in the business of brewing, processing, packaging, marketing, promoting and selling of beer products. It owned various brands comprising of trademarks, logos

and other devices, etc. The Applicant's trademark was registered in India which was exclusively licensed to Foster's India Ltd. along with licence to brew, package and sell beer in India. The Applicant received consideration for these licences, which it treated as royalty income and paid tax on it in India.

- Subsequently, the agreement granting the licence was terminated and the Applicant simultaneously entered into a Sale and Purchase Agreement (S&P Agreement) which was executed in Australia with a United Kingdom (UK) company for transfer of its shares and other intangible assets like intellectual property confined to the territory of India. Thereafter, the UK company nominated SKOL Ltd., an Indian company as the transferee of the assets under the S&P Agreement. A Deed of Assignment to this effect was entered into between the Applicant and SKOL Ltd.
- The question before the AAR was whether the trademarks and the manual for brewing beer (Brewing Manual) were capital assets situated in India, and whether the gains arising from their transfer by the Applicant, were taxable in India as capital gains under Sec. 9(1)(i) of the India Income Tax Act 1961 (ITA). Sec. 9 charges to tax all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or from any asset or source of income in India or through the transfer of capital asset situated in India.
- The AAR observed that if the transfer is of a capital asset situated in India, the consideration for the same will be taxable under Sec. 9(1)(i) of the ITA. It is immaterial in such a case that the actual process of transfer, such as the execution of transfer documents, had taken place outside India. "Capital asset" under Sec. 9(1)(i) means property of any kind held by an assessee whether or not connected with his business or profession and has a wide meaning which includes goodwill of business. Further, "property of any kind" includes intellectual property. Therefore, intellectual property which was transferred under the S&P Agreement would be a capital asset under Sec. 9(1)(i).
- The AAR rejected the Applicant's argument that the intellectual property was transferred back to Australia when the licence to Foster's India to use its trademarks was terminated, and hence the intellectual property was located in Australia and not in India on the relevant date of transfer since the Applicant was domiciled in Australia and the contract of transfer was executed in Australia. The intellectual property was registered and was being used in India, where the business of Foster's India was carried on in conjunction with the Applicant and therefore was located in India at the time of transfer irrespective of whether the location of the Applicant's trademarks could be traced to its place of domicile.
- Such trademarks and intellectual property had perceivable impact on the business being carried out in India and had a "tangible presence" in India at the time of transfer from tax perspective. As a result of transfer, the intellectual property that was being used by Foster's India till the date of its transfer would now be used and enjoyed by SKOL Ltd. Thus, the location of the capital assets was never shifted out of India. The goodwill related to the trademark and intellectual property could not be said to perish in India and be transferred to Australia by execution of the S&P Agreement.
- The AAR observed that registration of trademark had no bearing on its ownership and does not create an asset by itself. Registration of a trademark only confers statutory remedies for its effective protection. Nevertheless, registration of the Applicant's trademark in India was relevant in pointing to its existence in India and the recognition it has gained in India. The commercial exploitation of the trademarks and brand by the Applicant, aided by the marketing and advertising efforts of Foster's India, had resulted in the creation of valuable intangible asset in India. As such, from a commercial viewpoint, the assets in the form of trademark and brand together with the goodwill they generated were indeed situated in India when their transfer took place.
- However, income attributable to the grant of perpetual and irrevocable licence in relation to Brewing Manual was not taxable under Sec. 9(1)(i) of the ITA since it was intellectual property having physical identity which was shifted to Australia at the time of the S&P Agreement, and therefore could not be said to be situated in India on the date of transfer so as to give rise to any taxability in India.
- It was further observed by AAR that once the income is deemed to accrue or arise in India on account of transfer of capital assets situated in India, the entire consideration received for such transfer would be treated as gross income. Such receipt cannot

then be divided between the assets situated in India and those situated in Australia, where the owner entity is domiciled. It would not make any difference that the property could be notionally treated to be in existence also at the place where the owner resides. Accordingly, the AAR held that the entire receipt from the transfer of trademarks and intangible intellectual property, would be property taxable in India and the same cannot be split into two parts, i.e. one of it being related to Australia where the owner of the intellectual property is domiciled.

- Interestingly, the AAR rejected the argument of the tax authorities that the AAR should go behind the apparent tenor of the transaction to give effect to the substance of the transaction. The tax authorities argued that Foster's India was 100% owned by the Applicant and the intermediate companies were formed without any substance, merely to gain tax advantage. If one looked at the substance, the Applicant actually transferred the entire ownership of Foster's India to another Indian company, SKOL Ltd, as a result of which the said assets continued to be used in India. This, according to the tax authorities, showed that the situs of the capital assets so transferred was indeed in India.
- The AAR observed that it had held on merits of the case that the capital assets in the form of trademark and intellectual property were situated in India and subject to capital gains tax in India; therefore, a ruling on this issue was unnecessary. It would not be possible, on the basis of the limited material on record, to come to a definite conclusion whether in reality and in substance the entire Foster's India's business in India including shares and intellectual property were transferred by the Applicant as an integrated transaction. The AAR observed that the question whether any colourable device was adopted in routing the deal through various group companies and whether it was legally permissible to look through the smokescreen of transactions, were larger issues upon which the AAR need not comment in the current context.

## External commercial borrowings

- On 29 May 2008, the Reserve Bank of India ("RBI") issued A.P. (DIR Series) Circular No.43 (RBI/2007-08/339), amending certain aspects of the External Commercial Borrowings ("ECB") guidelines under RBI/2005-06/87 A.P. (DIR Series) Circular No.5 Dated. 01 August 2005.

- At present, pursuant to A. P. (DIR Series) Circular No. 04 (RBI/2007-2008/112) borrowers proposing to avail ECB up to USD 20 million for Rupee expenditure for permissible end-uses require prior approval of the Reserve Bank under the Approval Route.
- The RBI has decided that henceforth:
  - borrowers in the infrastructure sector may avail of ECB up to USD 100 million for Rupee expenditure for permissible end-uses under the Approval Route; and
  - in the case of other borrowers, the existing limit of USD 20 million for Rupee expenditure for permissible end-uses under the Approval Route has been enhanced to USD 50 million.
- The all-in-cost ceilings in respect of ECB have been modified.
- All other aspects of ECB policy such as USD 500 million limit per company per year under the Automatic Route, eligible borrower, recognized lender, end-use of foreign currency expenditure for import of capital goods and overseas investments, average maturity period, prepayment, refinancing of existing ECB and reporting arrangements remain unchanged.
- The amendment appears to arise primarily in the context of India's burgeoning infrastructure sector and also in the context of the need for increased investment in other sectors of the economy. Another much touted reason for the relaxation is the need of the RBI to shore up a depreciating rupee, and to allay inflationary pressures.
- Currently ECB can be raised only for investment (such as import of capital goods, new projects, modernization/expansion of existing production units) in the real sector, the industrial sector including small and medium enterprises (SME) and the infrastructure sector in India. The infrastructure sector is defined as (i) power, (ii) telecommunication, (iii) railways, (iv) road including bridges, (v) ports, (vi) industrial parks and (vii) urban infrastructure (water supply, sanitation and sewage projects). However, the terms "real-sector" and "industrial sector" continue to remain without definition.
- This circular does not amend the requirements by the RBI that borrowers proposing to avail of ECB up to the newly enhanced limits for Rupee expenditure for permissible end-uses would be required to park such funds overseas until actual requirement

in India. Further, the need for a prior RBI Approval for ECB up to the enhanced limit remains unchanged.

## Lower rate of capital gains tax also for foreign investors

- The Indian Authority for Advance Rulings (AAR) delivered a ruling dated 28 February 2008, in the case of McLeod Russel Kolkata Ltd. that a foreign company would also be entitled to the lower/concessional tax rate of 10% on long-term capital gains, earned on the sale/transfer (both terms used interchangeably) of shares of an Indian Company.
- Moran Holding PLC, a non-resident UK-based company had sold shares in an Indian Company to the Applicant, McLeod Russel India Ltd. The capital gain arising on such disposition of shares was taxable in India (Note. Capital gains are termed as long-term if they arise from shares, which were held for a period of more than 12 months prior to their transfer). The Applicant filed an application for an advance ruling as regards the rate of tax to be applied to such long-term capital gains.
- Under the proviso to Sec. 112 of the Indian Income Tax Act 1961 (ITA), long-term capital gains would be chargeable to tax at the lower tax rate of 10% (as against normal rate of 20%) if the tax exceeds 10% of the amount of the capital gains before giving effect to the provisions of the ITA that deal with the "indexation" of the cost of acquisition of capital assets.
- The tax authorities argued that Sec. 112 of the ITA makes a distinction between an Indian resident company and a non-resident foreign company and provides for tax rate of 20% for foreign companies. Therefore, a foreign company is not entitled to the benefit of the lower rate of 10% since they are not entitled to the benefit of indexation of the cost of acquisition of shares, etc.
- The key issue before the AAR was whether the Applicant, which was a non-resident in India, was eligible for a lower rate of tax of 10% on long-term capital gains arising in India on the sale of shares in an Indian Company.
- The AAR held that a foreign company was also entitled to the lower tax rate of 10% on long-term capital gains earned on disposition of shares of an Indian company. The AAR observed

that the proviso to Sec. 112(1) of the ITA was a special provision concerning the transfer of certain long-term capital assets (i.e. listed shares and securities, units, etc.), and there was no justification to limit the lower rate of 10% provided therein only to resident companies.

- The AAR also held that the eligibility to avail of the benefit of the "indexed cost of acquisition" was not a sine qua non or a pre-condition for applying the lower rate of 10% provided in Sec. 112 of the ITA. The indexation formula does not enter into the picture for computing the quantum of capital gains in the case of a non-resident foreign company. But that does not mean that Sec. 112 requires denial of this lower tax rate of 10% to foreign companies.
- The AAR concluded that no distinction could be made between an Indian resident company and a foreign company for applying the lower rate of 10% to long-term capital gains on sale of shares of an Indian company.

## Indonesia

### Reduction of the dividend withholding tax rate

- It was reported on 26 June 2008 that Indonesia government will propose reducing the final withholding tax on dividends paid to foreign investors from 20% to 15% as a way to improve the country's investment climate.
- The House of Representatives is reportedly drafting an income tax bill aimed at curbing widespread tax evasion as well as providing tax incentives to investors, who have been wary of investing in Indonesia because of the bureaucracy, uncertain legal system and corruption.
- The government will also propose reducing the corporate income tax rate from 30% to 28% in 2009, and then to 25% in 2010.

### Revaluation of fixed assets for businesses

- The Ministry of Finance has issued Regulation No. 79/PMK.03/2008, which is effective 23 May 2008 and replaces the former Decree No. 486/KMK.03/2002. Pursuant to the new regulation, an application can be submitted to the Director General of

Taxation for the revaluation of fixed assets, subject to the following rules:

- eligible persons are resident companies and permanent establishments that do not keep their books in English or their accounts in USD and who have fulfilled their tax liabilities up to the date of the last tax period before the revaluation;
- revaluations are permitted for all tangible fixed assets (including land) located in Indonesia and used for the purpose of deriving business income;
- the assets are to be revalued according to prevailing market rates or reasonable market value of the assets as stipulated by appraisal service providers or government-licensed appraisers;
- fixed assets that have been revalued may only be subsequently revalued after 5 years (under former Decision No. 486/KMK.03/2002, revaluations are possible once in every accounting period);
- the difference between the new market value and the previous book value of the assets is subject to a final tax of 10% which can be settled by 12 monthly instalments (under former Decision No. 486/KMK.03/2002, tax exceeding IDR 2 trillion could be settled within a 2 to 5-year period);
- once an asset has been revalued, depreciation is to be claimed on the new market value of the asset and based on the full useful life/benefit period for the group of the fixed assets;
- where a revalued asset is transferred before the new useful life elapses, additional income tax at the highest corporate tax rate (currently, 30%) less 10% will be imposed (under former Decision No. 486/KMK.03/2002, the tax was fixed at 20%); and
- any windfall from the difference due to the revaluations of fixed assets that is distributed to shareholders of the company is not subject to tax.

## Tax book value transfers of assets in case of business mergers

- The Director General of Tax has in March 2008 issued a circular PER 28/PJ2008 dealing with the use of tax book value on transfers of assets within the framework of business mergers and expansions. It takes effect immediately.

# Japan

## 2008 enacted legislation

- As mentioned in the previous Asia Newsletter, no consensus was reached on certain tax matters between the party of Japan's Prime Minister Fukuda and the opposition. As a result, the proposed amendments were not enacted. Nevertheless, the coalition under Prime Minister Fukuda recently overrode the decision by the (opposition dominated) House of Councilors not to accept the proposals by using its 2/3 majority in the House of Representatives. Below you find a summary of some of the changes.

### *PE risk independent agents*

- Unlike in the OECD Model Treaty and most double tax treaties, an independent agent was until recently from a Japanese tax perspective considered a permanent establishment (PE). Under the new rules that entered into force as of 1 April 2008, an independent agent is excluded from the domestic definition of a PE. The amendment should stimulate the onshore investment management activities.

### *Gasoline tax nevertheless extended*

- As mentioned earlier, no consensus was reached with regard to the extension of the gasoline tax. As a result thereof, the gasoline tax expired and gas became substantially cheaper in Japan. However, this only lasted for a very limited period since the gasoline tax of JPY 25.10 per litre was again extended as per 1 May 2008.

### *Capital gains tax reduction*

- A reduced rate of 10% (normally 20%) applies to capital gains realized by individuals on listed shares. This reduced rate will expire as per the end of this year. Under the new rules, the 10% rate will continue to apply to capital gains of JPY 5 million or less and to dividends received provided that the total amount does not exceed JPY 1 million.

### *Ruling system*

- Rulings could only be applied for past and current transactions. Under the amended rules, it is also possible to apply for a ruling on transactions that will take place in the future. In addition, the name of the tax payer applying for the ruling will no longer be disclosed. Also, the general term for the ATO

to issue a ruling will now be 3 months. No binding term exists for the ATO at the moment.

## OECD recommends revision of Japanese tax system

- According to the OECD, the negative impact of taxes on growth in Japan can be minimized by shifting the composition of taxes from direct to indirect taxes. As a result, they suggest that Japan should increase the GST rate. On the other hand, to stimulate growth, Japan should lower their corporate income tax rate which, currently at 42%, is one of the highest in the world (average among OECD countries is 29%). Also, the scope of the corporate income tax should be broadened.

## Special local corporate tax

- Due to changes in the local enterprise tax system, a new special local corporate tax will be introduced. This tax applies to years starting on or after 1 October 2008. It is expected that the total tax burden for taxpayers should not increase.

## Suggested exemption for repatriated earnings

- Under current rules, income generated from foreign subsidiaries is normally taxed in the hands of the Japanese corporate recipient. In an attempt to make Japan more competitive with other countries and to boost repatriation by Japanese companies of overseas profits, the Trade Ministry announced that it will make a proposal that earnings received from foreign subsidiaries should be exempt at the level of the Japanese parent company.

## Various / International

- Canada. Social security treaty between Canada and Japan generally entered into force as of 1 March 2008.

# Korea (R.O.K.)

## Announcement to reduce the corporate tax rate

- As mentioned in the previous edition of this newsletter, the Korean Ministry of Finance and Strategy already announced

plans to reduce the current corporate tax rate. Under recent announcements, the reductions will take place on shorter term and to a greater extent than expected; a reduction from 25% to 22% will take place as early as this year. In 2010, the rate should be further reduced to 20%. The background is that Korea aims to stimulate domestic demand and strengthen the economy's growth. The rate reduction is part of a more comprehensive plan that should achieve this boost to the economy.

## Tax rulings / Tax consolidation

- Korea is considering introducing the concept of tax consolidation. Also, they are considering the possibility for tax payers to apply for a ruling in order to be able to obtain certainty on the tax consequences of certain transactions.

## Capital gains from disposition of shares

- Korea amended the income tax law on the sale of Korean company shares by foreign companies. Prior to the amendment, if both the seller and purchaser of shares or contributions in a Korean company are foreign corporations without having permanent establishments in Korea, the purchaser was obliged to withhold and pay the respective taxes on capital gains to the appropriate tax office. Under the amendment, the seller is now obligated to file the corporate income tax return and pay the respective tax, unless the purchaser withholds and pays the appropriate tax on the capital gains derived from the transfer of securities as described under the following situations: (i) an owner of the underlying stocks transfers DRs after the conversion of the underlying stocks into DRs; (ii) stocks are acquired from outside the foreign listed market and are transferred within the foreign listed market; or (iii) securities denominated in Korean Won, which are traded outside of Korea, are transferred out of the foreign listed market. The amendment is effective for capital gains recognized from the disposition of shares on or after 1 January 2008.

## International tax developments

- For the first time, Korea signed a tax treaty with Latvia and Iceland. Negotiations are taking place between Kyrgyzstan and Korea to conclude a tax treaty.

# Malaysia

## Liberalization of foreign exchange rules

- With immediate effect, on 28 May 2008, the Central Bank of Malaysia (Bank Negara Malaysia) announced the further liberalization of foreign exchange administration rules in the following areas:
  - Borrowing in foreign currency by residents;
  - Borrowing in Malaysian ringgit (MYR) from non-residents; and
  - Lending in MYR by residents to non-residents.
- Foreign currency threshold. Previously, the threshold for foreign currency borrowings by a resident company was MYR 100 million on aggregate on a corporate group basis and MYR 10 million for resident individuals. Resident companies are now free to borrow any amounts in foreign currency from the following sources:
  - Its non-resident non-bank parent company;
  - Other resident companies within the same corporate group in Malaysia; and
  - Licensed offshore banks.
- In addition, a resident company is free to obtain any amount of supplier's credit in foreign currency for capital goods from non-residents. A resident company or individual is also free to refinance outstanding approved foreign currency borrowings.
- Borrowing in Malaysia Ringgit by residents from non-residents. A resident company is allowed to borrow in MYR (including through the issuance of MYR denominated redeemable preference shares or loan stocks) of any amount from its non-resident non-bank parent company to finance activities in the real sector (these are activities related to the aggregate supply and aggregate demand in an economy, i.e. including manufacturing, property, tourism, financial sectors, etc.) in Malaysia. The use for other purposes however is limited to MYR 1 million.
- Resident individuals are allowed to borrow up to MYR 1 million in aggregate from non-resident non-bank companies and individuals for use in Malaysia. Borrowings in MYR of any

amount from non-residents previously required the prior permission of the Controller of Foreign Exchange.

- Lending in Malaysia Ringgit by residents to non-residents. Resident companies and individuals are free to lend any amount in MYR to non-resident non-bank companies and individuals for the purposes of financing activities in the real sector in Malaysia. A licensed offshore bank is also free to lend any amount in MYR to non-resident non-bank companies and individuals to finance activities in the real sector in Malaysia.

# Philippines

## Disposals of shares of domestic companies

- The Bureau of Internal Revenue has in Revenue Regulations 6-2008, consolidated the rules for the imposition of tax upon the sale, barter, exchange or other disposition of shares of domestic companies that are held as capital assets.
- Pursuant to the Regulations, the taxes apply to individuals, companies, estates, trusts, trust funds and pension funds, amongst others. However, securities dealers, investors in mutual fund companies who realize gains from redemption of such shares and persons specifically exempt under investment incentives and special laws, are excluded. The Regulations also provide information on the timing of tax payments, the manner of filing returns and the consequences of non-payment of the taxes.
- The Regulations mainly cover the application of Philippine taxes for five types of share dispositions:
  - Sale, Barter or Exchange of Listed and Traded Shares. A stock transaction tax of 0.5% of the gross selling price or money value of the shares disposed of is payable by the seller of the shares.
  - Sale, Barter, Exchange or Issuance of Shares through Initial Public Offering. Tax of 1% to 4% is imposed on the gross selling price or money value of the shares. The rate of tax depends on the proportion of shares disposed of in relation to the number of shares outstanding. The tax is payable by the issuer corporation in a primary offering or the selling shareholder in a secondary offering.

- Sale, Barter or Exchange of Non-listed and Non-traded Shares. Capital gains tax is imposed on net realized capital gains at the rate of 5% for PHP 100,000 and below, or 10% otherwise.

- A capital gain arises where the sales receipts (sum of money received plus fair market value [FMV] of property) exceed the cost (basis or adjusted basis) of the asset, whereas a capital loss arises where the basis/adjusted basis exceeds the amounts realized.

- Where the FMV of the shares disposed of is more than the amount of money or FMV of the property received, the excess is deemed to be a gift that is subject to Philippines donor's tax, at prescribed scaled rates.

- FMV of listed shares sold outside of the trading system shall be the closing price on the date of sale, or nearest to the date of sale. FMV of non-listed shares is their book value in the audited financial statements nearest to the date of sale.

- Surrender of Shares Upon Dissolution and Liquidation of a Company. Regular income tax (currently, 32% for individuals and 35% for corporations) is imposed on the difference between the cash and FMV of the property received and the cost of the investment in the shares. The holding period rule applies to individuals. The percentage of taxable capital gain or deductible capital loss depends on the duration the shares are held.

- Shares Redeemed for Cancellation or Retirement. Upon the redemption of preferred shares, regular income tax is imposed on the difference between the amount received at the time of redemption and the cost of the preferred shares.

## Singapore

### Tax exemption scheme for family-owned investment holding companies

- Following up on the Government Budget released in February 2008, the Monetary Authority of Singapore (MAS) on 23 June 2008 issued a circular 04/2008 providing guidance on the income tax exemption given to qualifying family-owned investment holding companies. Essentially, the tax exemption hinges on the principle that the family-owned companies should be treated

the same as the individual owning it, and thus these companies should not be taxable on qualifying income earned in Singapore.

## Taiwan

### Foreign warehouses in Taiwan exempted from business taxes

- In recent years foreign corporations have developed a new way of doing business in Taiwan. Instead of setting up a branch or a wholly owned subsidiary, foreign corporations increasingly use warehouses (so-called logistics distribution centres) so as to be able to store their own products within the borders of Taiwan with an aim to fulfil orders for the company's products as quickly as possible. Contrary to branches and subsidiaries, for which the Taiwan tax treatment is clear, it was always unclear to taxpayers as to how such warehouses should be taxed.

- On 15 May 2008, the Minister of Finance issued a letter in which it explained that such warehouses would be exempt from Taiwan income tax as long as they meet the following conditions:

- The warehouses are only allowed to store products for and manufactured by the foreign corporations outside Taiwan;
- The stored products can only undergo some separating and packaging work in order to be distributed to customers in Taiwan;
- The products or parts may not be altered or improved while stored in Taiwan; and
- The products cannot physically, functionally or in any other manner be changed.

- If any of the above conditions is not met, a foreign corporation having such warehouse in Taiwan shall become subject to Taiwan taxes similar to branches and shall accordingly be subject to VAT and corporate income tax.

### Tonnage tax proposed

- The Ministry of Finance is studying the feasibility of introducing the tonnage taxation system for shipping firms, which will create a much lower overall tax burden. This move is aimed at

encouraging more Taiwanese shipping firms to register their vessels with Taiwan rather than using foreign flags of convenience like Liberia, Panama or Singapore. Under the tonnage tax system, shipping firms will be subject to tax according to their total shipping tonnage, and will be exempt from the existing business income tax. The Ministry of Finance proposal will be forwarded to the tax reform committee for study and approval.

## Thailand

### Thailand introduces new tax measures to stimulate the economy

- Thailand Cabinet, with a tax incentive decree effective 29 March 2008, has endorsed an economic stimulus plan that provides several personal income and corporate income tax exemptions.
- The personal income tax incentives include a personal income tax exemption on the first THB 150,000 (from tax year 2008) of income. Deductions for life insurance premiums have doubled from THB 50,000 to THB 100,000. Deductions for provident or pension funds have increased from THB 300,000 to THB 500,000.
- The corporate income tax incentives include an exemption on the first THB 150,000 of net profits for small and medium-size enterprises with paid-up capital not exceeding THB 5 million on the last date of the accounting period; a corporate tax reduction from 30% to 20% on net profits earned by newly listed companies on the Market for Alternative Investment; and a corporate tax reduction from 30% to 25% on net profits earned by newly listed companies on the Stock Exchange of Thailand.
- Another business incentive is a tax cut from 3% to 0.1% on the commercial or profitable sale of immovable property. Under the plan, the property transfer fee is reduced to 0.01% for both the transfer (previously 2%) and mortgage (previously 1%) of property and of condominiums, residences, and commercial buildings.
- The government predicts these new incentives will enable the Thai economy to achieve this year's targeted growth rate of 6%.

## Company Law amendments

- Effective 1 July 2008 the minimum 7 shareholders rule for Thai companies has been abolished and replaced by a minimum requirement of 3 shareholders. The new company law provisions also contain various positive amendments with respect to the procedure to reduce share capital, merge companies and incorporate new companies.

## Vietnam

### New Enterprise Income Tax and VAT Laws

- On 3 June 2008, the National Assembly of Vietnam adopted the new Enterprise Income Tax Law and the Value Added Tax Law, which will be applied from 1 January 2009. The important features of the laws are summarized below.

### New EIT Law

- The basic tax rate will be reduced from 28% to 25%;
- The exploration of mineral resources and oil and gas which is currently taxed at 28%, will be subject to rates ranging from 32% to 50%; and
- The current surtax on income from the transfer of land use rights and the transfer of the right to lease land will be abolished.

### Tax incentives new EIT law

- Business sectors entitled to tax incentives will be limited to high-tech industries, scientific research and technological development, infrastructure development, software production, education and training, medical services, sports and cultural activities, and environmental activities.
- The preferential tax rates will be amended to 10% and 20%, instead of the current 10%, 15% and 20%.
- Tax incentives are not granted for capital gains including the transfer of capital, real estate and the disposal of assets, interest income, foreign currency trading, recovered bad debts, income

from business activities outside Vietnam, precious mineral resources, oil and gas exploration, and electronic games of chance and betting.

- Based on the current law, the tax exemption and subsequent tax reduction periods commence from the first year in which taxable income arises. In addition, the first year of having taxable income is deemed to start by the fourth year the company generates revenue. This rule will continue to apply to companies which have been granted tax incentives under the current law, but have not yet generated taxable income when the new EIT Law comes into effect.
- Companies which have been granted tax incentives in accordance with the current law may continue to enjoy the incentives after the new EIT Law takes effect. However, if the new EIT Law offers more favourable incentives, the company may apply for them in the remaining period.

### **Deductibility of advertising and promotion expenses new EIT law**

- The deductibility of advertising and promotion expenses will remain restricted to 10% of total deductible expenses. However, the restriction is relaxed to 15% for newly established companies in the first three years of establishment.

### **Tax payment new EIT law**

- The new EIT Law amends the current system where taxes are paid at the head office level. From 1 January 2009, companies which have production branches located in provinces different from where the head office is located are required to pay taxes in both localities based on the proportion of expenses between the head office and production branch.

### **New VAT Law**

- Tax exempt supplies include the importation of equipment, machinery, specialized means of transport and construction materials not yet produced locally, unless used for scientific research and technological development or for oil and gas exploration. In addition, derivative financial transactions will also be treated as tax-exempt supplies.

- International transportation services (currently tax exempt) will be subject to 0% VAT when the new VAT Law enters into force; and
- A number of supplies which are currently subject to the 5% VAT rate will be shifted to the 10% category.
- Errors made in the declaration and deduction of input VAT can be corrected within a 6-month period; and
- Eligibility for input VAT deductions on purchases of more than VND 20 million would require a payment for the purchase being made via a bank.

- On 4 February 2008, the Vietnamese Minister of Finance issued an official letter to explain the application of the 0% VAT rate on exported goods and services. Whether or not an export of service and goods is zero-rated (i.e. subject to VAT at a rate of 0%) or is exempt from VAT, makes a big difference for the party exporting the goods or services as such party shall generally be entitled to claim input VAT (i.e. VAT charged by its suppliers) in case its supply of goods or services is zero-rated whereas such input claim is not available where the supply is exempt from VAT.

- The official letter stated that the 0% VAT rate is applicable to exported goods and services, including goods processed for export, construction and installation of overseas works and export-processing enterprises. It further stated that exported services are services directly provided for entities and individuals overseas and consumed outside the Vietnamese territory provided (i) service-providing establishments have contracts signed with overseas purchasers in accordance with Vietnamese Commercial Law and (ii) the overseas purchasers pay for services to service-providing establishments based in Vietnam.

### **International tax developments**

- Hong Kong. A 3rd round of negotiations was held for a first-time tax treaty between Hong Kong and Vietnam on 26-27 May 2008 in Hong Kong. A proposed Agreement was initialled at the conclusion of the negotiations. Further details will be reported subsequently.

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