

# Asia Pacific tax newsletter

August 2011

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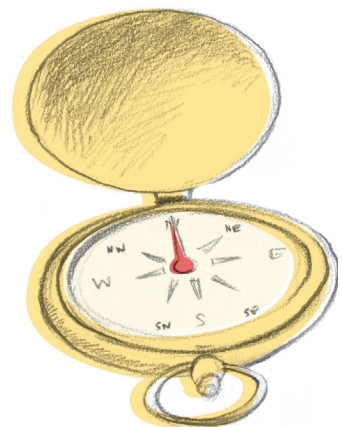
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Welcome to the first edition of the Asia Pacific tax newsletter. This newsletter aims to share major tax development in the region and to showcase the regional tax capabilities of Grant Thornton firms in Asia Pacific.

For further information on particular news items, please get in touch with your regular Grant Thornton contact or our tax practitioners indicated on the last section of this newsletter.



# Australia

## ATO set to review eligibility of carried forward losses



The Australian Tax Office (ATO) announced late last year that it will shortly be selecting taxpayers who disclosed carried forward tax losses in their 2009 income tax return, to determine whether these entities are carrying forward and/or utilising these losses correctly.

This is particularly topical given the economic climate in recent times and the likelihood that entities have incurred losses over the last few years which they will be looking to recoup in the upcoming years.

Whilst the ATO recognises that most entities are applying their losses correctly, they have identified some common mistakes. Here we highlight the areas of concern for the ATO which you may need to address.

### **Application of the continuity of ownership and same business tests**

The ATO has concerns about losses being used in circumstances where an entity does not satisfy the Continuity of Ownership Test (COT) or the Same Business Test (SBT).

Broadly, a company satisfies the COT if the same persons with the same interests hold more than 50% of the voting power, rights to dividends and capital at all times during the relevant test period. The relevant test period is generally from the start of the income year in which the loss is made until the end of the income year in which the loss is recouped. The test requires the entity to trace through companies, trusts and partnerships to natural persons who ultimately hold the interests.

Listed public companies and their subsidiaries may, if they so elect, apply the modified COT rules. The policy intention behind these concessions is to make testing the ownership of publicly listed companies easier to undertake in light of the inherent difficulties associated with tracing the ownership of companies that are so widely held.

Under the modified COT rules, a company need only apply the test of maintaining substantial continuity of ownership at the following points (test times):

- the start of the income year in which a tax loss is made;
- at the end of each 'corporate change' event; and
- the end of each intervening income year, which includes the income year in which the carried forward tax loss is to be deducted.

A corporate change, amongst other things, refers to a takeover bid, an arrangement involving more than 50% of the company's shares regulated under the Corporations Act 2001 and an increase in the issued capital or number of shares on issue by 20% or more. The modified COT provisions also include various tracing rules which are designed to make it easier for a company to satisfy COT. Very broadly, this includes a notional shareholder rule, whereby shareholdings of less than 10% are taken to be held by an individual shareholder and tracing is not required.

Where COT is failed, a company must pass the SBT in order to deduct a loss. The SBT is a three-fold test. In order to satisfy this test, a company must:

1. have carried on the 'same business' during the recoupment year as it carried on immediately before the change in ownership;
2. not have derived assessable income during the recoupment year from a 'business of a kind' which it did not carry on before the change in ownership; and
3. not have derived assessable income during the recoupment year from a 'transaction of a kind' that it had not entered into during the course of its business operations before the change in ownership.

Generally, the test points for recoupment of each bundle of carried forward tax losses under SBT are the latest time at which the company satisfied COT (i.e. just before COT was failed) and throughout the income year in which the losses are to be recouped.

However, the test points are modified for the purposes of transferring carried forward tax losses into a tax consolidated group.

The ATO has consistently taken a narrow view when considering what constitutes “the same business”. Taxpayers should prepare a detailed position paper to support the use of both tests and to protect and substantiate their losses.

#### **Losses transferred and used within a tax consolidated group**

The ATO has identified the following areas of risk for tax consolidated groups:

- losses being incorrectly transferred to the head company of a consolidated group
- losses being incorrectly used due to incorrect calculations of an Available Fraction (AF)

In order to transfer losses into a consolidated group, companies must satisfy COT or SBT, as discussed above. Failing these tests, the carried forward losses are not available for recoupment and may not be transferred to the head company when a consolidated group is formed or joined.

Where losses are transferred into a consolidated group, the use of these losses by taxpayers is limited by their AF. Broadly, the AF restricts the use of the losses by the head company to a rate which approximates the rate they would have been used by the joining entity had it remained outside the consolidated group.

An AF is calculated for each loss bundle by dividing the modified market value of the loss entity by the adjusted market value of the consolidated group at the joining time. The calculations ignore losses and assume a nil franking account balance.

The AF for each loss bundle is then multiplied against the taxable income of the group to work out the amount of transferred losses available for recoupment each year. Where there are losses remaining after applying the AF, these losses can be carried forward to be used in future years.

Taxpayers should review their AF calculations carefully. In particular, it is important to ensure that appropriate adjustments have been made to the AF whenever the group acquires another loss entity or the group’s market value changes as a result of capital injections or non-arm’s length transactions.

#### **Substantiation**

Another issue raised by the ATO is the lack of records kept to substantiate losses carried forward and recouped. Taxpayers should ensure they have records which document when and how they have incurred and recouped losses.

Carried forward losses not being correctly calculated

The ATO has also indicated that it has concerns with the calculation of losses. It is unclear what the ATO are targeting in this instance. However, this could be a broader mechanism for the ATO to scrutinise any adjustments made to a taxpayer’s taxable income that have contributed to that taxpayer being in a tax loss position.

Taxpayers and practitioners should ensure that they are comfortable with the positions taken in prior years which may have been a factor in them making the losses in those years.

#### **Conclusion**

The ATO’s announcement gives taxpayers a chance to get their files in order, finalise necessary position papers and ensure all loss calculations can be substantiated, in the event they are faced with a review.

## Proposed changes to GST cross-border transactions

On Tuesday 15 February 2011, Treasury released a discussion paper on proposed changes to GST cross-border transactions.

At this stage, Treasury is seeking written submissions in response to the proposed changes prior to the release of draft legislation.

The proposed measures are in response to recommendations arising from the December 2008 Board of Taxation's Review of the Legal Framework for the Administration of the Goods and Services Tax (BOT GST review).

### What are the changes?

Broadly, the proposed changes will effectively shift the burden of GST compliance and reporting to Australian residents and foreign entities with an Australian presence. In this way, they will have a substantial impact on the way you do business with overseas suppliers.

For example, if you transact with non-resident suppliers, the GST compliance burden may shift from them to you.

More specifically, the GST law will be amended to ensure that:

- GST registered entities with an Australian presence will be responsible for the GST implications of goods, services and intangibles supplied by a non-resident entity that does not carry on an enterprise in Australia
- GST registered entities with an Australian presence will be responsible for the GST implications of goods supplied to them under a lease, where the lessor is a non-resident that carries on an enterprise outside Australia and the goods are delivered or made available in Australia
- GST registered entities will be responsible for the GST on goods supplied to them by a non-resident if the non-resident does not carry on an enterprise in Australia and does not make supplies connected with Australia
- non-residents do not need to register for Australian GST in order to claim input tax credits on purchases made by them but provided to another GST registered entity in Australia.
- the supply of repair services (and parts) made to a non-resident but provided to another entity in Australia will be GST-free if the supply is made under a warranty agreement
- an Australian agent acting for a non-resident, who cannot conclude contracts on behalf of the non-resident, will be treated as a common law agent
- a non-resident entity that makes all its taxable supplies, creditable acquisitions and taxable importations through a resident agent will not be required to register for GST

- a non-resident entity will not be required to register for GST where it only makes GST-free supplies that exceed the GST registration turnover threshold
- GST registered importers will be able to determine the transport and insurance costs relating to a taxable importation using the actual amount incurred or an uplifted percentage of the customs value of the imported goods. The uplifted percentage is proposed to be 10%

### When do they apply from?

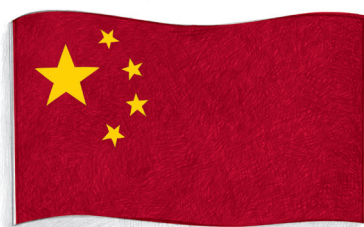
The proposed changes will apply from 1 July 2012.

### What do I need to do now?

If you believe you may be affected by the proposed changes, you should consider the implications these changes will have on your business.

# China

## New amendment to Chinese personal tax regime



### I. Introduction of the new amendment to personal tax regime

The National People's Congress decided by vote the amendment to the PRC individual income tax (IIT) law on 30 June 2011. The main changes stipulated in the amendment consist in two aspects:

- the monthly statutory deduction from salaries income will increase to RMB 3,500 (comparing to the current one at RMB 2,000); and
- the taxable income will be applicable to seven-level progressive rates ranging from 3% to 45% (comparing to the current ones between 5% and 45%), with the quick deduction changed accordingly.

The amendment to PRC IIT law will come into effectiveness from 1 September 2011.

#### Changed IIT rates table

Range no.	Monthly taxable income (RMB)	Tax rate	Quick deduction (RMB)
1	0 - 1,500	3%	0
2	1,500 - 4,500	10%	105
3	4,500 - 9,000	20%	555
4	9,000 - 35,000	25%	1,005
5	35,000 - 55,000	30%	2,755
6	55,000 - 80,000	35%	5,505
7	>80,000	45%	13,505

At the meantime, above changes will influence the tax calculation on the salary income derived by the expatriates working in China. Under the current rule, expatriates can enjoy a super deduction of RMB 2,800 further to the statutory deduction of RMB 2,000, i.e. generating a total deduction of RMB 4,800. With the new rule, the total deduction will increase to RMB 6,300 (i.e. the new statutory deduction of RMB 3,500 plus the super deduction of RMB 2,800). For expatriates, the taxable income after netting off the applicable deduction amount will also be applicable to the above IIT rates table.

The key feature of the change in rates is – broadening the range of lower salaries for low rates, while reducing the threshold for higher salaries for high rates.

There is a turning point set between above mentioned counterturns. If the salary is below the turning point, the tax liability calculated under the new rule will be less than that under the current rule. Otherwise, the situation turns back with the tax liability increased. The turning point for Chinese is RMB 38,600, and for expatriates RMB 41,400.

## II. Sample analysis for tax burden comparison

Case 1: A Chinese with monthly salary of RMB 12,000.

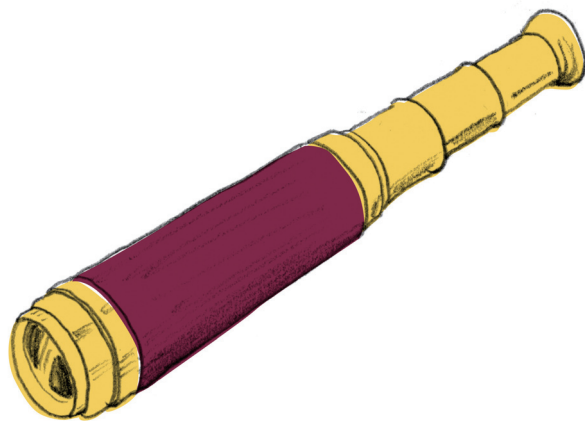
	Monthly salary	Taxable income	Tax rate	Quick deduction	Tax payable
	A	B	C	D	E=B x C-D
New rule	12,000	8,500	20%	555	1,145
Current rule	12,000	10,000	20%	375	1,625

The tax burden decreases by RMB 480.

Case 2: An expatriate with monthly salary of RMB 62,000.

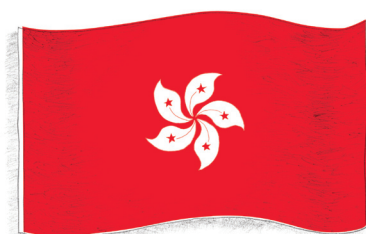
	Monthly salary	Taxable income	Tax rate	Quick deduction	Tax payable
	A	B	C	D	E=B x C-D
New rule	62,000	55,700	35%	5,505	13,990
Current rule	62,000	57,200	30%	3,375	13,785

The tax burden increases by RMB 205.



# Hong Kong

## Denial of apportionment of profits claim for import processing arrangement



In the case of *CIR v C G Lighting Limited*, the Court of Appeal (CA) issued its decision on 7 March 2011 denying the “50:50 apportionment of profits concession” to a Hong Kong company that has entered into an import processing arrangement with its Chinese subsidiary.

The 50:50 apportionment is a concession granted by the Hong Kong Inland Revenue Department in its Departmental Interpretation and Practice Notes No. 21. The concession is in recognition of many Hong Kong companies’ involvement in the manufacturing of goods in the Mainland by the management of the Hong Kong companies under a contract processing arrangement.

As a result of a shift in policy, the Mainland authorities no longer encourage the use of contract processing arrangement by Chinese companies to manufacture goods for Hong Kong companies. Many Hong Kong businesses have to transform their Mainland factories to wholly foreign owned enterprises and to change the contract processing arrangement to an import processing arrangement. Nonetheless, in many cases, the actual operations of both the Mainland factories and the Hong Kong companies have not changed at all, i.e. the Mainland factories are still heavily reliant upon the expertise of the Hong Kong management to manufacture the goods and to manage the entire operations. In many respects, only the legal form of the arrangement between the Mainland factories and the Hong Kong companies has changed, but nothing more.

The CA concurs with the views of the Commissioner of Inland Revenue that *C G Lighting* was a trader and not a manufacturer, and its trading activities were all carried out in Hong Kong, and thus all profits should be subject to tax in Hong Kong. The processing fees paid to the manufacturer, albeit a wholly owned subsidiary of *C G Lighting*, represented the costs it paid to acquire the finished goods from the factory and such costs have been deducted in arriving at the assessable profits from the subsequent sales of the products by *C G Lighting* in Hong Kong.

The CA decision reaffirms that the 50:50 apportionment concession is only granted to Hong Kong companies that have entered into contract processing arrangement with Mainland factories despite the fact that the Hong Kong companies are heavily involved in the manufacturing process even under the import processing arrangement. This seems to be a matter of form over substance, which seems to be very unfair to many Hong Kong businesses engaging in cross-border processing trade. There are many operational and other issues for converting the Mainland factories to wholly owned subsidiaries, and the change from a contract processing arrangement to an import processing arrangement. However, the fact of the matter is that the mode of operation before and after the conversion above has remained unchanged. To deny the concession by only concentrating on the form of the matter and not the substance would be very harsh for many Hong Kong businesses.

If your companies are involved in similar situations, please consult us to see how we can help to restructure the operations in a more tax efficient manner.

### **Commission income not subject to tax in Hong Kong**

On 18 April 2011, the Court of First Instance (CFI) released its judgement in *Li & Fung (Trading) Limited v CIR*. The decision was in favour of the taxpayer and confirmed the Board of Review's earlier decision that the taxpayer's commission income earned in respect of goods sourced from overseas suppliers was offshore in nature and hence not taxable in Hong Kong.

As many of you may know, Hong Kong's tax system is a territorial system; only profits that have a source in Hong Kong are taxable in Hong Kong.

In this case, the taxpayer provided services to its overseas customers, including the sourcing of products from outside of Hong Kong, overseeing the manufacturing process to ensure quality and to arrange for the shipment of the finished goods. The taxpayer received a commission income of 6% of the total FOB value of the customer's export sales.

The taxpayer subcontracted many of the above services to its overseas affiliates and they performed these services outside Hong Kong. The taxpayer paid these affiliates a fee of 4% of the FOB value of the goods exported.

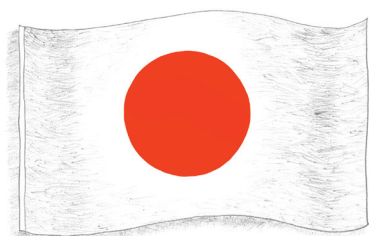
The Commissioner of Inland Revenue argued that the 2% earned by the taxpayer is for its services performed in Hong Kong and hence should be subject to tax in Hong Kong. The Board of Review rejected the Commissioner's argument and found that all the profit producing activities of the taxpayer happened outside Hong Kong, and it did not matter whether the overseas affiliates were agents or subcontractors of the taxpayer. The Board pointed out that the focus had to be on "establishing the geographical location of the taxpayer's profit producing transactions themselves as distinct from activities antecedent or incidental to those transactions", a principle established in the case of *ING Baring Securities (Hong Kong) Limited v CIR* in 2007.

The CFI agreed with the views of the Board, that the activities performed by the taxpayer in Hong Kong were antecedent activities which, although commercially essential to the operations and profitability of the taxpayer's business, do not provide the legal test for ascertaining the geographic source of profit. The CFI thereby upheld the Board's decision that the taxpayer's profits arose directly from the activities performed by its affiliates outside Hong Kong and therefore from a foreign source, and hence those profits should not be subject to tax in Hong Kong.

We are waiting to see whether the Commissioner will lodge an appeal to a higher court. In the meantime, if your companies are involved in similar arrangements, please do consult us to see if you should also lodge an offshore claim on these profits.

# Japan

## New incentives for inbound investment into Japan



The 2011 Tax Reform proposals outlined tax incentives for qualifying corporations to invest in specified areas of Japan and to establish Regional Headquarters and Research and Development (R&D) centres here. In addition a reduction to corporation tax rates was announced. The proposals will be debated and the tax laws in their final form will be promulgated in late March. A brief outline of the measures is given below.

### Investment in designated areas

In order to promote investment into certain areas qualifying corporations engaged in specified types of business in the areas, which are yet to be designated, will be eligible for either of the following benefits:

- a first year depreciation deduction of 50% of the cost of certain capital expenditure (25% for buildings) will be available from taxable income, or alternatively a tax credit can be taken for 15% of the cost (8% for buildings). The credit is capped at 20% of a corporation's tax liability with the balance able to be carried forward for one year;

- if the above incentive is not taken, a 20% reduction in taxable income is available for companies incorporated and conducting business primarily in the designated area.

In order to qualify for one of the above incentives a corporation must be a blue tax return filer and be approved by an authorized local government. These requirements must be completed between the effective date of the tax law and 31 March 2014.

The depreciation regime described above will apply to expenditure incurred between the effective date of the tax law and 31 March 2014. The reduction in taxable income will apply for five years from the date the corporation is designated as qualifying.

### Incentives for regional headquarters and research and development centres

Another measure contained in the proposals is designed to encourage foreign corporations to establish Regional Headquarters or R&D centres in Japan. Corporations will benefit from a 20% reduction to taxable income for five years from the date they are designated as qualifying. In the fiscal years that the incentive is taken, no tax credits for R&D costs will be available.

To qualify for this incentive a corporation needs to be a blue tax return filer and have its Headquarters or R&D Business plan approved by a Competent Minister. The period for approval runs from the effective date of the tax law to 31 March 2014.

### Reduction in corporation tax rates

For fiscal years beginning on or after 1 April 2011 the headline corporation tax rate will be reduced from 30% to 25.5%. This will cause the effective tax rate for a company to be reduced from approximately 41% to approximately 36%.

For Small and Medium-sized Enterprises the special tax rate of 18% applicable to the first 8 million Yen of taxable income will be reduced to 15% for periods beginning between 1 April 2011 and 31 March 2014. For periods beginning on or after 1 April 2014 the rate will revert to the normal rate, which will also be reduced to 19% from 22%.

### Subsidy program for projects promoting asian site location in Japan

In conjunction with the Tax Reform proposals, the government has announced that subsidies will be made available to private enterprises for projects that establish new Headquarters or R&D sites in Japan.

### **Eligibility requirements**

In order to be eligible for the subsidy the project needs to meet the following criteria:

- it should establish a new site as opposed to relocating or consolidating existing sites;
- it must belong to a corporate body with group companies operating business in two or more countries.

The enterprise needs to be incorporated in Japan. However, foreign corporations with no corporate status in Japan may apply for the subsidy program. If successful they must have corporate status in Japan by the time of the first grant application.

### **Available subsidies**

Enterprises deemed to be Small and Medium-Sized Enterprises (SMEs) under the program will be able to claim subsidies for up to half of the eligible costs, with non-SMEs able to claim up to one-third. Costs eligible for subsidy include survey and design costs, facility costs and rental charges and equipment costs. The maximum subsidy available is 1 billion Yen.

### **Application**

Applications for the subsidy program will be accepted by the Japan External Trade Organisation (JETRO) until 22 March 2011.

### **Summary**

The tax reform proposals and subsidy program highlight the Japanese government's intention to increase the attractiveness of Japan as a location for investment in the region. The reduction in corporation tax rates together with the tax incentives and generous subsidies available will encourage both domestic and foreign corporations to establish new sites and invest in Japan, which in turn will help to stimulate the Japanese economy.

# Korea

## Mandatory issuance and filing of an electronic VAT invoice for corporate taxpayers



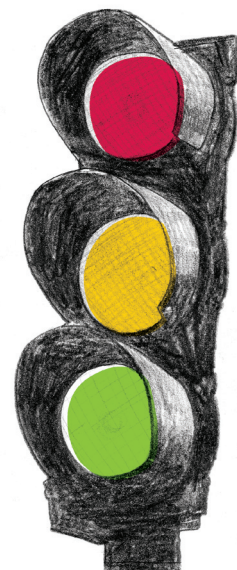
Under the revised VAT Law of Korea, a mandatory electronic VAT invoicing system is taking effect on or after 1 January, 2011. That is, from 2011, VAT invoices should be issued in an electronic form and the electronic VAT invoices issued should be transferred to the National Tax Service (NTS) on a monthly base.

If a corporate taxpayer fails to issue an electronic tax invoice or still issues a paper tax invoice, the following penalties will be imposed.

- the penalty of 2% of the amount supplied shall be assessed for failure of issuance of an electronic VAT invoice
- if fails to transmit the electronic tax invoices to the NTS by the 15th of the following month, the penalty of 0.3% (1% from 2013) shall be assessed in addition to the above mentioned penalty

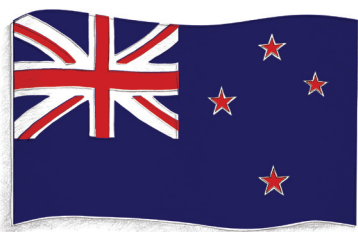
For issuance of an electronic VAT invoice, there are three types of methods prescribed under the VAT Law as below.

- 1. The Enterprise Resource Planning (ERP) method**  
A taxpayer may establish a module to issue an electronic tax invoice in the existing ERP system.
- 2. The Application Service Provider (ASP) method**  
A taxpayer may choose a certified ASP and provide the ASP with the details about the issuance of VAT invoices.
- 3. The NTS Electronic tax invoice system method**



# New Zealand

## International Tax Hit Parade – the Top 10 misconceptions



The list, reproduced below, highlights important principles that impact the way New Zealand tax law operates, and are not necessarily intuitive. It reinforces the fact that many taxpayers have tax obligations that are not immediately obvious and may require them to seek advice. This is the list produced by the IRD:

1. New Zealand residents are not just taxed on income they earn in New Zealand but also on their worldwide income.
2. If a person leaves New Zealand but maintains a permanent place of abode here, they are still a New Zealand resident for tax purposes.
3. Foreign income, including investments (even if deposited in an offshore account or left on a foreign credit card), is taxable in New Zealand even if it's not repatriated to New Zealand.
4. If withholding tax is deducted on foreign income, it does not mean this income is no longer taxable in New Zealand.
5. A foreign tax credit may be available but only where the tax involved is not subsequently refunded. It's similar to income tax, and less than or equal to the tax otherwise payable on underlying income in New Zealand.
6. Not all overseas pension payments are tax free. In fact, some may be fully taxable in New Zealand.
7. Special taxing regimes (controlled foreign company and foreign investment fund rules) apply to gains on certain foreign shareholdings, retirement schemes and life insurance investments.
8. Additional disclosures may be required in respect of controlled foreign companies and foreign investment funds.
9. Allowances that may be tax free in other countries (for example, living-away-from-home allowances) are generally fully taxable in New Zealand.
10. The temporary tax exemption on foreign income for transitional residents expires after 48 months and there is no entitlement to Working for Families Tax Credits during the exemption period.

The first point to draw from this list is that tax residents are taxed on worldwide income, regardless of where it is earned or received.

The second is that certain economic interests outside New Zealand can give rise to tax issues in New Zealand, whether or not they produce what most people consider an income stream.

Thirdly, deductions are not available for the costs incurred by salary and wage earners against that income.

New Zealand law applies at all times, regardless of whether the tax treatment in a foreign country agrees with it.

Note that outside of the actual tax obligation, the holding of certain interests can generate disclosure obligations to the IRD even though there is no tax payable. Certain concessions can have wider implications outside of tax, and if the taxpayer is enjoying New Zealand's transitional residents exemption, care should be taken when accessing Working For Family Tax Credits.

In summary, the release of the IRD list is a timely reminder that all taxpayers who think they may not be fully complying with their tax obligations should seek professional advice.

## Tinkering around the tax edges

Following the significant tax changes arising out of the 2010 budget, including a GST rate increase and broad income tax cuts, this year's budget was always going to be about consolidation of the policy initiatives, sustainability and tinkering around the edges.

The Government signalled well in advance its intention to modify the three key platforms administered by the Inland Revenue, being Working for Families, Student Loans, and the KiwiSaver schemes. All have been modified, essentially to make them sustainable in the long term.

Significant growth over the past few years in costs associated with all three schemes, meant changes had to be made to ensure they could remain viable. Any fundamental change, however, was never on the cards given how entrenched all three regimes are in the New Zealand psyche and the political suicide resulting from any major change.

Working For Families is being amended at the "wealthy" end of the scheme. There is a modest reduction in the abatement threshold from \$36,827 to \$35,000, and an increase in rate of abatement from 25% to 20%. There is also a temporary halt in the inflation indexation for payments relating to children aged 16 and over until they align with those for children aged 13 to 15. All these changes will be drip fed at the time of the next four CPI

inflation adjustments, which are expected biannually.

Student loan changes are intended to reduce the cost of the scheme by focussing on the areas where a greater loss to Government arises. Changes include restricting access to further loans to those who are in arrears with their payments, limiting access to the scheme for those aged 55 and older to tuition fees only, denying access for part-time full year students, shortening a repayment holiday for students going overseas from three years to one and widening the definition of income for student loan repayment purposes.

The most significant changes to the KiwiSaver regime effective 1 April 2012 are the removal of the exemption from Employer Superannuation Contribution Tax, where the tax liability will be at the marginal tax rate applying to the member, and a halving of the Member Tax Credit to a maximum of approximately \$10 per week. These reductions to a member's scheme contributions will be offset by increasing the minimum employee contribution rate from 2% to 3% from 1 April 2013 with an equal rise in the compulsory employer contribution rate. The initial kick-start payment of \$1,000 will remain.

In addition to its existing tax work programme, the Government has also indicated an intention to generally tinker through new rules for mixed-

use assets (targeting yachts and holiday homes), a new approach to livestock valuation elections for farmers (to stop flip flopping between regimes), and to capture as taxable more non-cash benefits to employees.

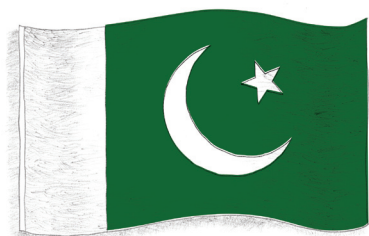
The banks are not exempt from the tinkering either, with a change in the thin capitalisation ratio for foreign owned banks, with the minimum prescribed equity percentage increasing from 4% to 6%.

Importantly, the Government has indicated a continued focus on audit activity and debt enforcement action meaning taxpayers will continue to feel the direct hand of Inland Revenue in their affairs.

After one of the heaviest year of tax changes in recent history, a tinkering was not unexpected and a welcome relief from that pace of change.

# Pakistan

## Latest budget brief



Finance Minister Dr. Abdul Hafeez Sheikh unveiled the budget proposal for the year 2011-12 in the National Assembly on 3 June 2011 making an increase of 14.2% against the last fiscal year budget. The total budget for the year is projected at PKR2,757 billion (\$32 billion). The revenue collection is expected to be 9% of Gross Domestic Product (GDP).

The budget is aimed at reducing fiscal deficit to 4% of GDP whereas GDP growth is targeted at 4.2%. The budget aims to contain inflation at 12% as compared to 15.5% for FY 2010-11. The government aims to strengthen restructuring of loss making public sector enterprises including opting for privatization or closure.

Finance Minister has declared reduction in GST from 17% to 16% when regulatory duties on 392 items were to be removed. 3.2 million people were brought into tax net. All special excise duties have also been abolished. A rise of 15% in Salaries of Government employees has been approved by Government and pension will be increased by 15% to 20%.

### Fiscal & economic review

The overview of budget 2010-11 reveals deficit of PKR 961 billion i.e. 5.3% of GDP growth against the target of PKR683 billion i.e. 40% of GDP. Thus the economy of Pakistan reflected slow growth over last five years. The fall in GDP is mainly caused by slower growth rate in agriculture and manufacturing sector. Energy shortfall, high interest rates and crowding out private sectors credit were the factors responsible for major drag on growth in manufacturing sector. However service sector contributed up to 90% of GDP growth.

During FY 2010-11, Rupee against dollar stabilized.

Certain tax measures were taken by the Government that include the following:

- withdrawal of sales tax exemption on agriculture inputs both at domestic and import stages
- one-time surcharge of 15% was imposed on income tax due in respect of income arising during the period 15 March 2011 to 30 June 2011
- special excise duty rates were enhanced from 1% to 2.5% on non essential items

Federal Board of Revenue (FBR) has achieved tax collection target of PKR1,588 billion for FY 2010-11 taking the collections to 9.2% of GDP. The ratio would be 9.6% of GDP for FY 2011-12, as the revenue collection is budgeted at PKR1,952 billion.

### Direct taxes

Changes made in direct taxes through Finance Act, 2011 are summarized below:

### Enterprise tax rate

The rate of tax on company, small company, and AOP remains unchanged i.e. 35%, 25% and 25% respectively.

### Personal income tax rates

The tax threshold for individual taxpayer has been increased from PKR 300,000 to PKR 350,000.

### Tax rates for individual taxpayer other than salaried taxpayer

Taxable income (PKR)	Tax payable
Up to 350,000	0
350,00- 500,000	7.50%
500,000- 750,000	10%
750,000-1000,000	15%
1000,000-1,500,000	4.50%

### Tax rates for salaried taxpayer

Taxable income (PKR)	Tax payable
Up to 350,000	0
350,00- 400,000	1.50%
400,000- 450,000	2.50%
450,000-550,000	3.50%
550,000-650,000	4.50%
650,000-750,000	6.00%
750,000-900,000	7.50%
900,000-1,050,000	9.00%
1,050,000-1,200,000	10.00%
1,200,000-1,450,000	11.00%
1,450,000-1,700,000	12.50%
1,700,000-1,950,000	14.00%
1,950,000-2,250,000	15.00%
2,250,000-2,850,000	16.00%
2,850,000-3,350,000	17.50%
3,350,000-4,550,000	18.50%
More than 4,550,000	20.00%

In case the income of a taxpayer marginally exceeds the maximum limit given under a slab in the above table, the income tax payable would be the tax payable on maximum of that slab plus amount equal to:

- 20% of the amount by which the total income exceeds the said limit where the total income does not exceed PKR550,000
- 30% of the amount by which the total income exceeds in each slab but total income does not exceed PKR1,050,000
- 40% of the amount by which the total income exceeds in each slab but total income does not exceed PKR2,250,000
- 50% of the amount by which the total income exceeds in each slab but total income does not exceed PKR4,450,000
- 60% of the amount by which the total income exceeds in each slab but total income exceeds PKR4,450,000.

The tax charge for the year in respect of salaried individual shall be lower of:

- tax liability under normal regime
- tax liability under marginal tax relief

### **Tax credit for equity investment**

A new tax credit equal to 100% of tax liability has been introduced for companies establishing a new industrial undertaking in Pakistan on or after 1 July 2011. This credit is also available to a company who makes investment in installation of machinery for the purpose of Balancing, Modernization and Replacement (BMR) of plant & machinery in an existing industrial undertaking.

### **Tax credit for listing on stock exchange**

Rate of tax credit available to companies that opt for listing has been increased from 5% to 15%.

### **Advance tax on cash withdrawal**

The rate of advance tax on cash withdrawals from bank account has been reduced from 0.3% to 0.2% of the withdrawn amount.

### **Turnover & minimum tax resident persons**

'Turnover' for the purpose of minimum tax now includes Gross Sales and Gross Receipts i.e. inclusive of sales tax, federal excise duty or trade discounts if any. The period for carry forward of minimum tax for adjustment against tax liability in subsequent years has been extended to 5 years from earlier 3 years while the rate of minimum tax remains unchanged i.e. 1%.

### **Personal income tax return & wealth statement**

The amendment has been made to require filing of return by commercial and industrial connections holders of electricity and by persons enjoying 'income from business' not exceeding threshold for taxable income.

### **Taxation of Permanent Establishment (PE) of non-resident person**

Payment received by PE of non-resident person has been brought under the ambit of Final tax Regime in respect of execution of contracts whereby tax deducted at source is considered as final discharge of tax liability. In respect of service contracts, tax deducted at source is considered as minimum tax. Non-resident person having PE in Pakistan are displaced from the facility of obtaining advance ruling from FBR.

### **Tax implication on payment of goods and rendering of services**

Tax withheld from payment against sale of goods shall be treated as final tax except in case of manufacturers and listed companies whereas tax deducted from payment on account of rendering of services shall be minimum tax. Tax deducted from payment in respect of execution of contracts shall also be treated as final tax other than for listed companies.

### **Capital value tax**

CVT on purchase of shares of listed companies, instruments of redeemable capital and modarba certificates has been abolished.

### **Other taxes**

#### **Adjustable input (sales) tax**

The earlier restriction of claiming input tax up to 90% of output tax has been withdrawn. Now registered persons are allowed to claim total input tax adjustment in the period incurred.

#### **Federal Excise Duty (FED) on beverages**

Rate of FED on aerated water and fruit juices etc has been reduced to 6% of retail price.

# Philippines

## Tax treatment of guarantee fee under RP-Korea Tax Treaty



Compensation for guarantee of loans paid by a local power generation company to a nonresident power generation company organized and existing under the laws of Korea is not considered in the nature of business profits but “other income” under the Republic of the Philippines (RP)-Korea Tax Treaty.

The guarantee fees are not derived by the nonresident company from its primary activity of power generation. Likewise, the compensation for guarantee of loans is not in the nature of such types of income covered by the RP-Korea Tax Treaty such as income from real property, shipping and air transport, dividends, interest, royalties or capital gains. Considering, however, that the RP-Korea Tax Treaty has a provision (Article 22) dealing with Other Income, such provision will govern the taxation of compensation for guarantee of loans.

Under Article 22 of the RP-Korea Tax Treaty, compensation for guarantee

of loans shall be taxed only in Korea where the nonresident power generation company is a resident, except in the case where the compensation is attributable to a permanent establishment of the company in the Philippines. Inasmuch as the nonresident company does not have a branch, an office, or any other fixed place of business in the Philippines, it is considered as not having a permanent establishment in the Philippines. Hence, the compensation for guarantee of loans received by it from the local company is exempt from Philippine income tax. (BIR Ruling No. ITAD 134-11, April 25, 2011)

## Application of MFN clause under RP-US Tax Treaty

Under the RP-US Tax Treaty, royalties derived in the Philippines by a company in the United States (US) for its web-based performance and talent management service or use of its “know how” by a domestic company are generally subject to 25% or a lower rate of 15% if the payor-domestic company is registered with the Board of Investment (BOI) and engaged in preferred areas of activities. Pursuant to the most-favored-nation (MFN) clause of the treaty, the same royalties may also be subject to the lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of another treaty country.

In the instant case, the US company invoked the RP-Czech Tax Treaty as granting the lowest tax at 10% on royalties derived from the Philippines by a Czech company. Applying the MFN clause, the BIR held that the royalties derived by the US company may be subject to the lower 10% tax prevailing under RP-Czech Tax Treaty if it satisfies the two conditions cited by the Supreme Court (SC) in the case of *Commissioner of Internal Revenue v. SC Johnson and Son, Inc.* v. Court of Appeals (GR No. 127105).

Under the SC decision, these two conditions are: (a) the royalties derived

by a US resident must be of the same kind as those derived by the resident of the other treaty country; and (b) the mechanism employed by the two countries in mitigating the effects of double taxation of foreign-sourced income derived by its residents must be the same.

Under the RP-US Tax Treaty, payment received by a resident of the United States as a consideration for the use of or the right to use patents, information concerning industrial, commercial or scientific experience (know-how), and copyright of literary, artistic or scientific work are all considered royalties. When

received by a resident of the Czech Republic, the same income payments are likewise deemed in the nature of royalties, and subject to income tax rate of 10% on the gross amount thereof under the RP-Czech Tax Treaty. Considering that the royalties derived by a resident of the US is of the same kind as those derived by a resident of the Czech Republic, the first condition for the MFN tax treatment of royalties is satisfied.

As to the second condition, the mechanism employed in mitigating the effects of double taxation of income derived from foreign sources is the ordinary credit method under the RP-US Tax Treaty, which is similar to the mechanism provided under the RP-Czech Tax Treaty. Hence, since the RP-US and RP-Czech treaties provide for similar mechanism in avoiding the effects of double taxation of its residents, the second condition is also satisfied.

Considering that the two conditions for the MFN tax treatment of royalties are both satisfied under the RP-US and RP-Czech treaties, the royalties paid by the domestic company to the US company are subject to 10% preferential tax rate pursuant to the RP-US Tax Treaty in relation to the RP-Czech Tax Treaty. (BIR Ruling No. 126-11, 15 April 2011)

## Prior ITAD ruling requirement for tax treaty relief

Any availment of the tax treaty provisions should be preceded by an application for tax treaty relief with the International Tax Affairs Division (ITAD) of the BIR. Otherwise, a taxpayer cannot avail of the preferential tax treatment under Philippine tax treaties.

In filing for requests for tax treaty relief and refund of overpaid final withholding tax (FWT), the taxpayer-refund claimant should comply with all the requirements laid down under Revenue Memorandum Order No. (RMO) 1-2000 (prevailing at the time of transaction and now superseded by RMO 072-10) for applying for tax treaty relief, and Section 229 of the Tax Code for the requirements in filing of administrative and judicial claims for refunds.

In the instant case, the taxpayer-refund claimant filed both its application for relief from double taxation, and claim for refund of its overpaid FWT on

cash dividends it paid to its foreign stockholders with the BIR ITAD more than one year from the payment of dividends to its stockholders. As provided under RMO 01-2000, all applications for tax relief with BIR ITAD should be filed at least 15 days before the transaction, i.e., payment of dividends in order to avail of the preferential tax treatment under the Philippine tax treaties. In as much as the taxpayer failed to comply with the 15-day requirement, having filed its application after more than a year from its payment of dividends to its shareholders, the CTA held that the taxpayer-refund claimant cannot avail of the preferential tax rate under the relevant tax treaty.

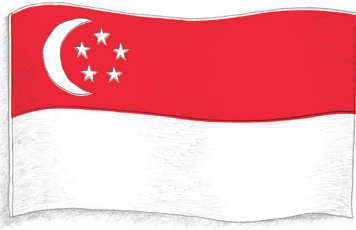
In addition, the CTA found that the taxpayer-refund claimant did not file an appropriate written claim for refund with the BIR since its alleged claim for refund was considered an application for relief from double taxation filed with the ITAD and not a categorical claim for

refund filed with the BIR as required by Section 229 of the Tax Code.

Lastly, the taxpayer-refund claimant never presented the original BIR Form 1601-F but only the amended BIR Form 1601-F (Monthly Remittance Return of Final Income Taxes Withheld) and BIR Form 2306 (Certificate of Tax Withheld at Source). As held by the CTA, it is imperative for the taxpayer to present in evidence the original BIR Form 1601-F to determine the exact date when the FWT was paid to the BIR, while BIR Form 2306 filed by the taxpayer cannot be considered by the CTA since it does not show the fact of payment made to support the FWT remittance. Hence, the taxpayer's claim for refund of its overpaid FWT on dividends it paid to foreign shareholders was denied by the CTA. (Manila North Tollways Corporation v. Commissioner of Internal Revenue, CTA No. 7864, 12 April 2011)

# Singapore

## New Protocol – Singapore / India DTA – Exchange of information



Is the new Exchange of Information Article under the newly signed Protocol between India and Singapore going to have the teeth it needs to be effective to identify astute tax planning?

Singapore has signed a protocol agreement with India amending the Double Tax Treaty (DTA) between the two countries on 24 June 2011. However, the Protocol has yet to be ratified and will only come into effect once this is done between the two countries.

The Government of the Republic of Singapore and the Government of the Republic of India, desiring to conclude a Second Protocol to amend the Agreement between the Governments of The Republic of Singapore and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed at India on 24 January 1994, as amended by the Protocol signed at India on 29 June 2005 (hereinafter referred to as “the Agreement”).

The two countries have agreed to amend the Exchange of Information article to the Agreement.

The new Article 28 (Exchange of Information) provides for the following;

Para 1 provides that:

**“The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Agreement or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Agreement.”**

Para 2 states that:

**“Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.”**

As can be noted, the protocol is yet another step in the right direction for Singapore’s willingness to align itself with the international community in being transparent and open and a leap away from the taint of once being on the OECD grey list.

Singapore has signed several such agreements in recent years to rectify this position and is no longer on the grey list.

The impact of this Agreement respects the confidentiality of the information per se but also enables the tax authorities of both states to use such information obtained against the taxpayer in determining assessment as well as legal proceeding to recover income taxes avoided in that other state.

What will be interesting is to see how Article 5 will be applied. Article 5 provides that:

**“In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.”**

It shall be interesting to see to what extent either competent authorities go through to play ‘detectives’ for the other state to obtain such confidential information given that both states have to respect banking confidentiality more so in Singapore given its status as an international and regional banking and financial center.

Article 3 states that:

**“In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:**

- a. to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- b. to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State.”

Whilst the above article seems to provide a safe harbor escape route to the full impact of this Article being applied to the detriment of taxpayers, it is not without question that there is always room for each competent authority to interpret the application as narrowly or broadly as it may wish to.

“Discretion and confidentiality” has been the overriding pillar of support underpinning confidence in the Singapore banking and financial sector. Any information disclosed pursuant to the application of this Article to remotely destabilize this confidence could have far reaching consequences given that Singapore is a global player in the private banking sector. This is a sector which the government is promoting and has been a huge success in the past decade.

Discretion and confidentiality is key to the continuing success of this industry.

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