KPMG

General tax update for financial institutions in Asia Pacific

TAX

February 2005 issue 14

Highlights

Australia	• Changes in legislation • Court cases • Other developments
Hong Kong	• New Department Interpretation and Practice Notes published • Additional Notes on Advance Ruling Case No.16 • Second consultation paper on exemption of offshore funds from Profits Tax
India	• Advance ruling cases • Court cases • Other developments
Japan	• Tax reform 2005
Korea	• Dividends from subsidiary eligible for dividend income deduction • Abrogation of disallowed interest expense on debt exceeding the limit specified under the tax law • Dividend income deduction for certain investment vehicles
Malaysia	• Changes in Legislation
Philippines	• Documentary stamp taxes
PRC	• Changes in treatment of business tax and stamp duty
Sri Lanka	• Fiscal Proposals 2005
Taiwan	• Transfer pricing assessment rules

Country

Australia

Tax update

Changes in legislation

- On 18 November 2004, the Tax Laws Amendment (2004 Measures No. 6) Bill 2004 was introduced into the House of Representatives. The new measures include:
  - Consolidation - the Bill contains new rules allowing entities to revoke certain choices or elections when they consolidate, join consolidated groups and/or leave consolidated groups. The amendments have retrospective effect to 1 July 2002.
  - Consolidation - the Bill aims to provide greater flexibility, clarify certain aspects of the consolidation regime and ensure that the regime interacts appropriately with other aspects of the income tax law. The amendments cover membership rules and insolvency, finance leases, expenditure relating to mining or quarrying, low value and software development pools, notice requirements for inter-entity loss multiplication, source of certain distributions for allocable cost amount purposes, certain step 3[1] losses and transitional treatment of tax liabilities. These amendments have retrospective effect to 1 July 2002.
  - Debt and equity interests - the transitional treatment for at call loans under the debt/equity rules will extend to 30 June 2005.
- On 18 November 2004, the New International Tax Arrangements (Managed Funds and Other Measures) Bill 2004 was reintroduced into the House of Representatives. The new measures relate to:
  - Capital gains tax and foreign residents - the measures amend the law to provide favourable tax outcomes for foreign residents investing in Australian managed funds rather than investing directly into comparable assets.
  - Treaty source rules - the amendments will align the tax treatment under the International Tax Agreements Act 1953 of foreign residents investing through managed funds that derive some or all of their income from sources outside Australia with the tax treatment that would apply if those foreign residents made such investments directly.
  - Interest withholding tax - Schedule 3 to the Bill implements three distinct amendments that relate to the imposition of interest withholding tax (IWT). They seek to ensure that the IWT provisions operate as intended and are consistent with recent developments in the tax law. The first amendment broadens the range of financial instruments eligible for IWT exemption by adding “debt interests” as debt for tax purposes. The second amendment treats payments of a non-capital nature made on certain Upper Tier 2 hybrid capital instruments as interest for IWT purposes. The final amendment allows assets and debts to be transferred from Australian subsidiaries of foreign banks to their Australian branches without losing IWT exemptions.
- On 8 December 2004, the Tax Laws Amendment (2004 Measures No. 7) Bill 2004 was introduced into the House of Representatives. The Bill contains amendments, relating to the following areas, with respect to consolidation:
  - Amount of certain liabilities for the purpose of calculating allocable cost amount on exit - this ensures that certain liabilities taken into account when an entity leaves a consolidated group that correspond to liabilities brought into a consolidated group with a joining entity have the same value at the leaving time that the liabilities had at the joining time.
  - No double reduction - this ensures that there is no double reduction in working out step 3 of the allocable cost amount on entry.

  - Bad debts - this ensures that when debts connected with a consolidated group are written off, the claimant can claim a bad debt deduction.
- On 9 December 2004, a package of seven Bills was introduced concerning the collection of supervisory levies for financial entities. The package is aimed at reducing the burden of supervisory levies on medium-sized businesses in favour of increased burdens on small and large businesses.
- On 12 December 2004, the Tax Laws Amendment (Small Business Measures) 2004 received Royal Assent, becoming Act No. 134 of 2004.

Court cases

- On 19 November 2004, the High Court of Australia, in Equuscorp Pty Limited & Anor v Glengallan Investments Pty Limited [2004] HCA 55, decided that a "round-robin" arrangement under which money was lent to investors of a tax-effective investment scheme may still legally be considered a loan, even if the economic effect of the arrangement is otherwise.
- On 10 December 2004, the High Court refused the taxpayer's application for special leave to appeal the decision of the Full Federal Court in Spassked Pty Ltd v Commissioner of Taxation [2003] FCAFC 282.
  The Full Federal Court decision now stands confirmed. The decision held that interest deductions were not available under Section 51(1) of the Income Tax Assessment Act 1936 (ITAA 1936) for interest expenses incurred by the taxpayer group company on borrowings from the group finance company, which were used to subscribe for shares in another subsidiary in the group. Tax Commissioner, Mr Michael Carmody, said this case was significant because of the fact that it demonstrated the Australian Taxation Office's (ATO's) ability to successfully investigate and challenge the most complex of arrangements that overstep the mark of the Australian tax laws.
- On 6 January 2005, the Full Federal Court, deciding on an appeal from Spotlight Stores Pty Ltd v Commissioner of Taxation [2004] FCA 650, confirmed that a prepayment into an employee benefit trust fund was caught by the general anti-avoidance provisions of Part IVA of the ITAA 1936.
  The Court was unable to find a commercial rationale for the timing of the contribution or the round robin arrangements to effect the contribution for future staff bonuses, leading to the conclusion that the dominant purpose was to obtain a tax benefit.

Other developments

- On 1 January 2005, the Minister for Trade, Mr Mark Vaile, issued a media release announcing the commencement into force of the Australia-United States Free Trade Agreement on 1 January 2005. According to Mr Vaile, the benefits to exporters will flow through immediately.
- On 12 January 2005, the ATO released Draft Taxation Ruling TR 2005/D1: Income Tax: branch funding for multinational banks. The Draft Ruling focuses on the application to inter-branch funds transfers of Australia's Permanent Establishment (PE) attribution rules and the business profits article in Australia's double taxation agreements. It also deals with the attribution of equity capital to a PE of a bank and focuses on the interaction of Australia's PE attribution rules and Division 820 of the Income Tax Assessment Act 1997.
- On 24 January 2005, the Treasurer, Mr Peter Costello, issued a media release announcing that, following the adoption of International Financial Reporting

Standards (IFRS) on 1 January 2005, the Government will provide a three-year transitional period for the purposes of the thin capitalisation regime. During the transitional period, taxpayers will be able to undertake their safe harbour calculation using Australian Generally Accepted Accounting Principles as they existed pre-1 January 2005. The transitional period will provide sufficient time for the Government to examine whether the existing thin capitalisation rules are appropriate following the adoption of IFRS.

[1]At Step 3 of an allocable cost amount calculation, an amount is added for the undistributed, frankable profits of a joining entity that have accrued to membership interests held continuously by the joined group until the joining time. The purpose of this step is to prevent double taxation by allowing the group a cost for retained taxed or taxable profits that accrued to membership interests when they were continuously held (as can occur where there is an incremental acquisition of an entity).

Hong Kong

New Departmental Interpretation and Practice Notes published

As a consequence of the amendments by the Inland Revenue (Amendment) Ordinance 2004, the Inland Revenue Department (IRD) issued a new Departmental Interpretation and Practice Note (DIPN) No. 13A on the deductibility of interest expenses. The IRD also revised DIPN No. 13 and DIPN No. 34 in respect of taxation of interest received and exemption of interest income from Profits Tax. The amendments and additional guidance are highlighted below.

Deductibility of interest expenses (DIPN No. 13A)

DIPN No. 13A elaborates on the conditions for interest deduction in respect of borrowings from financial institutions and persons other than financial institutions (i.e. the Secured Loan Test and the Interest Flow Back Test). This DIPN also discusses the tax treatment of interest expenses on debentures or debt instruments. These are summarised below.

Where the interest expense is incurred in earning Hong Kong assessable profits:

- An interest expense deduction is allowed, provided that the loan is not secured by a deposit or loan, the interest on which is not taxed in Hong Kong, made by the borrower, a person associated with the borrower, with or to the lender, a financial institution or an overseas financial institution. For this purpose, security by way of a loan or deposit made to an associate of the lender, financial institutions or overseas financial institutions also causes interest disallowance.
- An interest expense deduction is allowed, provided that there is no arrangement in place whereby the interest payment is ultimately paid back to the borrower or to a person connected with the borrower (the Interest Flow Back Test). The term “arrangement” is defined as “any agreement, arrangement, understanding, promise or undertaking, whether expressed or implied, and whether or not enforceable or intended to be enforceable, by legal proceedings” and “any scheme, plan, proposal, action, or course of action or course of conduct”.
- For an interest deduction on debentures and debt instruments, the instrument is now required to be “marketed” rather than “marketable”. Whether a debt instrument is marketed is a matter of fact to be determined by reference to the common market practices.
- Exemption is given to a market maker who holds such debentures or instruments in the ordinary course of conducting his business of market making. A holding of over 5% of an issue for a period of over 3 months will not be taken as a holding of the securities in the ordinary course of one’s

marketing making activities unless the Commissioner is satisfied that there are reasonable explanations for doing so.

- The new law also permits an apportionment of interest expense to allow an interest expense deduction where only a portion of the interest qualifies for deduction, or where the arrangement was only in place for part of the basis period in question.

Taxation of interest received (DIPN No. 13)

DIPN No. 13 has been updated to include reference to the decision in **Orion Caribbean Limited v CIR 4 HKTC 432** and, more specifically, the "operation test". DIPN No. 13 states that the provision of credit test, i.e. the place where the money was first made available to the borrower is not applicable where the loans involved are not simple loans of money. The operation test should apply to determine the source of the profits where a taxpayer earned its profits by borrowing and lending money. The operation test requires one "to see what the taxpayer has done to earn the profit in question and where he has done it".

Exemption from Profits Tax (Interest Income) Order 1998 (DIPN No. 34)

Consistent with the amendments relating to an interest expense deduction, DIPN No. 34 stresses that the exemption does not apply to any deposit which is used to secure or guarantee a loan of money where the conditions specified in the Secured Loan Test and the Interest Flow Back Test of the interest expense deduction provisions are satisfied. In such case, the interest expense is allowable and the interest income is not exempt from the payment of tax by the Order.

Additional notes on Advance Ruling Case No.16

The IRD has provided additional notes to Advance Ruling Case No.16 which was discussed in Issue 12 of this publication. The IRD has emphasised that the subject of the ruling was whether the foreign subsidiary or the London Branch was carrying on business in Hong Kong. The IRD concluded that on the facts presented, an agency could be implied and hence the foreign subsidiary or the London Branch was ruled to be carrying on business in Hong Kong through the Hong Kong Branch.

The IRD reiterated that the applicant did not request or present sufficient information for them to decide whether the foreign subsidiary or the London Branch had profits arising in or derived from Hong Kong.

The ruling was specific to the facts of the case as presented to the IRD and should not be interpreted as a ruling for general application.

Draft DIPN on taxation of financial instruments and foreign exchange differences

Subsequent to the issue of Hong Kong Accounting Standards (HKAS) 32 and 39 (which are the Hong Kong equivalents of International Accounting Standards 32 and 39), the IRD has circulated a draft DIPN for comments setting out the tax implications in respect of various financial instruments to which HKAS 32 and 39 apply.

Second consultation paper on exemption of offshore funds from Profits Tax

A second stage consultation is being undertaken in respect of the above. A revised consultation paper (the Second Consultation Paper) was issued by the Financial Services and the Treasury Bureau (FSTB) on 31 December 2004. For a copy of the Second Consultation Paper, please visit the following website:

http://www.fstb.gov.hk/tb/eng/info/con-paper-ptax.pdf

The Second Consultation Paper outlines a revised approach to providing an exemption of offshore funds from Profits Tax. Under the revised approach, it is proposed that two sets of provisions will be enacted in the Inland Revenue Ordinance (IRO):

- The Exemption Provisions; and
- The Deeming Provisions.

Offshore profits and capital gains derived by offshore funds will remain non-taxable.

Exemption Provisions

In the first consultation paper on the exemption of offshore funds issued in January 2004, it was proposed that the funds would have to be 80% beneficially owned by non-resident investors in order to be eligible for the exemption. This 80% test has been removed in the Second Consultation Paper.

The Exemption Provisions will apply to exempt an offshore fund from tax in Hong Kong where the fund is a non-resident. Although much will hinge on the definition of a resident, which has not been defined in the Second Consultation Paper, the revised approach to provide a broad based exemption to non-resident funds represents a significantly step forward for the fund management industry in Hong Kong.

However, we remain concerned about certain aspects of the Exemption Provisions outlined in the Second Consultation Paper, which may undermine their effectiveness and limit the application of the exemption to true offshore funds. These are summarised below:

- The proposed rules exempt the non-resident person from profits tax in respect of any profits derived from securities trading transactions undertaken in Hong Kong through an agent who is a broker or an approved investment adviser under Section 20AA of the IRO. This requires the brokers and investment advisors not to be associated with the fund or transact in an independent capacity. Certain funds may find it difficult to comply with the associate and independence requirements as it is not an uncommon industry practice to have an investment interest in a fund by the brokers or the investment advisors.
- The exemption is applicable to profits earned by the non-resident person from "securities" trading transactions only. This condition may result in genuine non-resident funds such as foreign exchange funds, commodity funds and private equity funds not qualifying for the exemption that is contemplated in the Second Consultation Paper.
- For the exemption to apply, the non-resident person must not carry on any other business in Hong Kong. This is expected to affect some global asset management groups that do not have any direct business or activities in Hong Kong but may undertake some custodian or other ancillary administrative services performed through agents in Hong Kong.

Deeming Provisions

In order to prevent round-tripping by local funds, new anti-avoidance provisions have been proposed in the form of Deeming Provisions. A Hong Kong investor can be subject to tax on Hong Kong sourced trading profits derived by another entity (i.e. the fund) under a type of "accruals taxation" basis.

It appears from the Second Consultation Paper that such provisions may operate without any regard to actual distributions made by the non-resident fund to the resident investor and may have unintended wider application and be complex to administer.

India

Advance ruling cases

- In **Instrumentarium Corporation, In re – A.A.R. No. 609 of 2003** dated 25 November 2004, the Authority for Advance Ruling (AAR) ruled that income or expenditure from every international transaction has to be computed having regard to the arm's length price irrespective of whether the transaction results in an erosion of India's tax base or not. The applicant, a non-resident company, entered into an agreement with its Indian subsidiary which granted it an interest free loan. The applicant sought a ruling from the AAR to ascertain whether it would be required to comply with the transfer pricing regulations as per the domestic tax law with respect to the interest free loan transaction as the application of the arm's length price would actually erode the tax base in India to the extent of tax differential[2] on such interest.

  The AAR declined to opine on whether a particular transaction is in accordance with the principles of arm's length but ruled that the applicant would be required to comply with the transfer pricing regulations.

- In **M/s Emirates Fertilizer Trading Company WLL, In re- A.A.R. No. 628 of 2004** dated 27 October 2004, the AAR has ruled that capital gains derived by a resident of the United Arab Emirates (UAE) on the sale of shares of Indian companies are not taxable in India in view of Article 13(3) of the Double Taxation Avoidance Agreement (DTAA) between India and UAE. The applicant was a partnership firm, a resident of UAE and held a residency certificate of UAE. The AAR observed that the taxability of a non-resident under the Indian Income Tax Act would not depend upon whether the subject income is taxable in the non-resident's home country (in this case, the UAE). The taxability of the subject income would be governed in accordance with the provisions of the DTAA between India and UAE, if applicable or in accordance with the domestic laws. Since pursuant to Article 13(3) of the DTAA between India and UAE, capital gains derived by UAE residents arising on the sale of shares of Indian companies are taxable only in UAE, the capital gains on such sale will not be taxable in India.

Court cases

- In **Morgan Stanley and Company International Limited In re A.A.R. No. 611 of 2003** dated 29 November 2004, the AAR ruled that, income from trading in exchange traded derivatives is business income and not income from capital gains. The ruling is based on:
  - The feature of the derivative instrument, i.e. short life span, no yield of any income therefrom, and income is derived only on the purchase and sale of such transaction held as stock in trade; and
  - The principles laid down in the ruling of the AAR in **XYZ / ABC Equity Fund [2001] 250 ITR 194** i.e. the substantial volume of the transactions, the magnitude and ratio between purchase and sale etc.

  If the non-resident foreign institutional investor does not have a PE in India, such business income derived would not be taxable in India in view of the India - United Kingdom tax treaty provisions.

Other developments

- The Central Board of Direct Taxes vide its notification **no. 288/2004 [F. No 142/44/ 2003-TPL]** dated 1 December 2004 has clarified that taxpayers have to quote a Permanent Account Number **interalia** in respect of payments of INR 50,000 or more for the purchase of units of a mutual fund, acquisition of shares issued by a company, debentures/bonds issued by a company/institution or bonds issued by the Reserve Bank of India.

[2]This represents the difference between tax saving on interest for the Indian Company (36.75%) and interest taxable in the hands of the applicant on gross basis (10%), being a tax differential of 26.75%.

Japan

Tax reform 2005

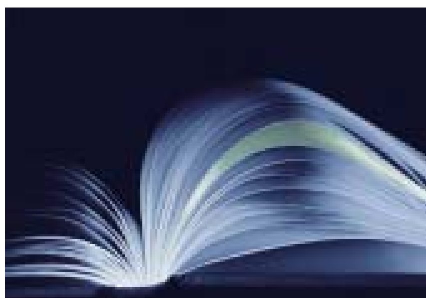
The Liberal Democratic Party-led Ruling Coalition agreed on a blueprint outline of the 2005 Tax Reform (Blueprint) on 15 December 2004. The Blueprint introduced new rules and measures to both corporate and individual taxpayers on various issues including tax credits, utilisation of tax losses, tax deduction for contributions or donations, capital gain on disposal of shares in a Japanese company and Japanese real estate, withholding tax on profit allocation, anti-tax haven rules and transfer pricing regime. These changes are subject to the submission to the 2005 Ordinary Diet Session.

The Blueprint introduced changes in partnership taxation which may impact some leasing arrangements. A new rule similar to the Passive Activity Loss Rule in the U.S. will be introduced for individual partners. Where individual partners of an NK[3] or an NK type partnership that is involved in rental real property activity incurs losses from the rental activity, such losses will be disregarded for income tax purpose and cannot be carried over to the following years. This rule will not apply to an individual partner who is involved in decision-making of important operations of the activity and who participates in operations such as negotiating contracts.

Rental real property activity includes not only rental business of land and buildings but also leasing ships and aircrafts. The purpose of the rule is understood to be to prevent individual taxpayers from offsetting losses incurred from investments in aircraft leasing arrangements through an NK or an NK type partnership against any other active income. This rule will be applied from 2006 for national income tax purposes and from 2007 for inhabitant tax purposes (which will be taxed based on 2006 income).

[3] A "Nini-kumiai" (NK) is formed among two or more parties by contract in which the parties agree to carry on a joint undertaking by making a contribution under the Japanese Civil Code. Some characteristics of NK arrangements are similar to those of a general partnership. NK is treated as a pass-through arrangement for Japanese tax purposes.

Korea



Dividends from subsidiary eligible for dividend income deduction

Under the existing law, a certain percentage of dividend income received by a Korean company (excluding Holding Companies[4]) from its domestic subsidiaries is not recognised as taxable income. Under a revised regulation in the Corporate Income Tax Law, effective from 1 January 2005, where a Korean company owns 100% of the shares in its subsidiary, the total amount of dividend income received from its subsidiary is not recognised as taxable income.

Dividend income received from subsidiaries is excluded from gross income on a gradual basis as follows:

Type of Subsidiary	% of shareholding	% of excluded income	Description
Non- listed Corporation	100%	100%	Revised regulation
	Less than 100% more than 30%	50%	Existing Law
	30% or below	30%	Existing Law
Listed Corporation	100%	100%	Revised regulation
	Less than 100% - more than 50%	50%	Existing Law
	50% or below	30%	Existing Law

Abrogation of disallowed interest expense on debt exceeding the limit specified under the tax law

Previously, under the Corporate Income Tax Law, where debts exceeded four times a listed company's equity, interest paid on such excessive debt was not tax-deductible. Effective from 1 January 2005, the regulation disallowing the deductibility of interest on excessive equity was abolished. The revision was implemented in light of the fact that the debt-equity ratio of most companies has been reduced to a reasonable level as a result of restructuring, and that such a uniform regulation did not take into account the specific needs of certain companies.

Dividend income deduction for certain investment vehicles

The proposed deduction for dividend income in respect of certain investment vehicles as addressed in our previous issue was passed by the National Assembly. The deduction is effective from 23 April 2005 for a consignment agent of real estate investments and from 1 January 2005 for Private Equity Funds.

[4] "Holding Companies" are referred to as specific companies incorporated under the Anti-trust and Fair Trade Act or the Financial Holding Company Law. These "Holding Companies" enjoy specific benefits provided by the act or the law. This term does not include general companies which just own shares in other company.

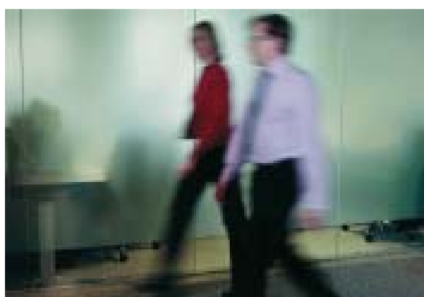
Malaysia

Changes in Legislation

- With retrospective effect to 11 September 2004, tax exemption is available on interest income derived by a non-resident company, other than interest derived by a place of business in Malaysia of such company, in respect of:
  - securities issued by the Government; or
  - Islamic securities or debentures issued in Ringgit Malaysia, except for convertible loan stock, approved by the Securities Commission.
- Interest-in-suspense would be deemed as a specific provision for bad debts in the case of a bank[5] and allowed as a deduction for income tax purposes effective from the year of assessment 2001.

[5] "Bank" means a bank or a finance company or a banking and finance company licensed or deemed to be licensed under the Banking and Financial Institutions Act 1989 or Islamic Banking Act 1983, or an institution prescribed under the Development Financial Institutions Act 2002.

Philippines



Documentary stamp taxes

The Philippine Bureau of Internal Revenue issued a Revenue Regulation dated 23 December 2004 [Revenue Regulations No. 13-2004] which clarifies several provisions of the legislative amendments [Republic Act No. 9243] made for documentary stamp taxes (DST). Some guidelines of interest to financial institutions are as follows:

- DST now applies to all instruments representing borrowing and lending transactions under a single heading "All Debt Instruments" and a new unitary tax rate is applied thereon. "Debt Instrument" means instruments representing borrowing and lending transactions including but not limited to:
  - Debentures, certificates of indebtedness, due bills, bonds;
  - Loan agreements, including those signed abroad wherein the object of the contract is located or used in the Philippines;
  - Instruments and securities issued by the government or any of its instrumentalities;
  - Deposit substitute debt instruments;
  - Certificates or other evidences of deposits that are drawing interest significantly higher than the regular savings deposit taking into consideration the size of the deposit and the risks involved;
  - Certificates or other evidences of deposits that are drawing interest and having a specific maturity date;
  - Orders for payment of any sum of money otherwise than at sight or on demand; and
  - Promissory notes, whether negotiable or non-negotiable, except bank notes issued for circulation.
- All such debt instruments are now subject to DST of one peso (P1.00) on each two hundred pesos (P200.00) or part thereof, of the issue price of the debt instrument. The term "issue price" refers to the face value of the debt instrument.
- DST is payable on every original issue and the DST is based on the issue price. Sale of a debt instrument in the secondary market will not be subject to DST.
- If the debt instrument has a term of less than one year, DST shall be computed taking into consideration the number of days that the instrument is outstanding as a fraction of 365 days. If the debt instrument has a term of one year or longer, the DST due shall be computed based on the issue price of the debt instrument.

- For purposes of determining whether a certificate or document evidencing deposits are subject to DST, the following rules apply:
  - Any deposit bearing interest, irrespective of the nomenclature and whether covered by a certificate, passbook or any other evidence of deposit, where the interest is significantly higher than the rate given to regular savings deposits, is subject to DST.
  - All types of deposit accounts with a higher interest yield than that given to savings deposits or where the interest rate earned by such deposit is reduced upon pre-termination, are likewise subject to DST.
  - Interest is considered as "significantly higher" if it is at least fifty percent higher than the lowest interest rate given by that bank or financial institution on any of its deposits, whether the same be savings/demand deposits. A regular savings/demand deposit are those which are withdrawable upon demand by the depositor and earn rates of interest at the rate prevailing for a regular savings/demand deposit, irrespective of the amount deposited.
  - Any deposit bearing interest, irrespective of the nomenclature and whether covered by a certificate, passbook or any other evidence of deposit is considered to have a maturity date, and be subject to DST if there is a predetermined or defined specific maturity or end date to the deposit as agreed to by the depositor or there is a defined program of enjoyment of higher interest rate, a privilege or other benefit to be extended by the bank or financial institution if the said deposit is to be maintained by the depositor for a defined period of time.
- DST of thirty centavos (P0.30) on each two hundred pesos (P200.00), or part thereof is to be collected on the face value of all bills of exchange (between points within the Philippines) or drafts. This is intended to complement the DST imposed on "all foreign bills of exchange" which are "drawn in but payable out of the Philippines" under Section 182 of the National Internal Revenue Code.
- The following documents and papers are exempt from DST:
  - Fixed income and other securities, exclusively referring to debt instruments, traded in the secondary market or through an exchange;
  - Derivatives issued by entities duly licensed or authorised by the Bangko Sentral ng Pilipinas (BSP). For the purposes of this exemption, repurchase agreements and reverse repurchase agreements are treated similarly as derivatives;
  - Bank deposit accounts without a fixed term or maturity; and
  - Inter-bank call loans with maturity of not more than seven days to cover deficiencies in reserves against deposit liabilities which are also exempted from DST, including those between or among banks and quasi-banks.
- The DST rate is applicable on all documents not otherwise expressly exempted by the said law, notwithstanding the fact that they are in electronic form.
- The Regulations shall apply to all transactions made or to documents/ instruments executed or issued as of 20 March 2004, i.e. the date when R. A. No. 9243 took effect.

People's Republic of China

Changes in treatment of business tax and stamp duty

The PRC State Council announced certain measures in early 2004 to encourage the development of the mainland capital market. As part of the development, the Ministry of Finance and the State Administration of Taxation recently issued notices on Business Tax and Stamp Duty to facilitate the development of the mainland capital market participants.

Starting from 1 January 2005, the Business Tax treatment on the following practices has been changed:

- The transaction administration fee withheld by Shanghai Stock Exchange and Shenzhen Stock Exchange is now deductible for Business Tax purposes;
- The transaction administration fee withheld by Shanghai Futures Exchange, Shenzhen Futures Exchange and Dalian Futures Exchange is now deductible for Business Tax purposes;
- The following fees withheld by securities/stock brokers/futures brokers can be deducted for Business Tax purposes:
    - Transaction administration fee withheld for the stock exchange;
    - Security agency service fee withheld;
    - Shareholder account-opening fee (including A-shares and B-shares), account transferral fee, B-shares settlement fee and entrustment fee withheld for China Securities Depository & Clearing Corporation Limited; and
    - Handling fee withheld by futures brokers for the particular Futures Exchange can be deducted for Business Tax purposes.

Starting from 24 January 2005, the Stamp Duty rate on trading of securities will be reduced from 0.2% to 0.1%, which applies to all dutiable documents for buying and selling, inheriting and donating A-shares and B-shares.

Sri Lanka

Fiscal Proposals 2005

- With retrospective effect from the Year of Assessment 2003/04, the exemption from Income Tax on trading profits on secondary market dealings in Government Securities (excess of inherent yield) has been withdrawn.
- With effect from 1 April 2005, the 10% withholding tax applied to discounts on issue of Corporate Debt will be abolished.
- With effect from 1 January 2005, a 0.2% transaction levy is imposed on both the buyer and seller in respect of trading of listed shares on gross proceeds, but the 15% tax on profit on sale has been withdrawn.
- With effect from 1 January 2005, stockbrokers and other intermediaries other than financial institutions involved in the sale of shares are exempt from special VAT on financial services.
- With effect from 1 April 2005, the deductible threshold for head office expenses of a foreign branch is limited to 10% of taxable income for Income Tax purposes.

Taiwan

Transfer pricing assessment rules

On 28 December 2004, the Taiwan Ministry of Finance (MOF) promulgated the Assessment Rules Governing Non-Arm's Length Transfer Pricing for Profit-seeking Enterprises Income Tax (TP Assessment Rules) which were effective from 30 December 2004. Multinational companies operating in Taiwan must take immediate action to assess whether their related party transactions are at arm's length under the TP Assessment Rules. The salient features of the TP Assessment Rules are highlighted below:

Definitions of related party

In addition to the 20% ownership interest, the MOF also adopts the "substantive management and control" and "material influence" concepts in defining what constitute a related party relationship.

Transfer pricing methodology

The transfer pricing methods under the TP Assessment Rules are similar to those provided under Section 482 of the U.S. Internal Revenue Code (IRC) and the OECD transfer pricing guidelines.

In relation to a taxpayer's selection of the transfer pricing method to apply, the "best method rules", similar to the U.S. rule, would be used. In addition, the application of an inter-quartile range (i.e. between the 25th to 75th percentiles) as the arm's length range is required where the data of the comparables is not sufficiently complete to allow for identification of the differences with the controlled transactions or adjustments to be made for these differences.

Disclosure requirements

An enterprise must disclose related party transactions on new forms to be filed with income tax returns. The types of information to be disclosed include:

- Legal structure;
- Detailed information on related parties;
- Controlled transaction types, respective amounts, ending balances of associated receivables/payables;
- Transfer pricing method used; and
- Whether the taxpayer signed any Advance Pricing Agreement (APA) with tax authorities in Taiwan or foreign tax jurisdictions, and the relevant details.

Contemporaneous documentation

Taxpayers must, at the time of filing annual income tax returns, maintain an extensive list of documentation and a transfer pricing report to support the controlled transactions (the Transfer Pricing Report). Upon request, taxpayers are required to produce the documentation within one month from the date of receipt of notification. Taxpayers are also given the option of a one-time extension of an additional month. In general, all the required documentation is to be provided in Chinese; however, to alleviate the enterprises' compliance cost, English language documentation could be acceptable if approved by the tax authorities.

Tax adjustments and penalties

If the transfer pricing audit results in tax adjustments, a penalty up to 200% of the adjustment amount (where the enterprises have timely filed tax returns) will be imposed under any one of the following situations:

- Where the reported controlled transaction prices are 200% or more, or 50% or less of the arm's length prices as assessed by the tax authority;
- Where the income adjustment assessed by the tax authority reaches 10% of the taxpayer's assessed annual income and 3% of the assessed annual net sales;
- Where the taxpayer fails to provide the transfer pricing report and cannot provide other documentation to prove that its transfer price result is at arm's length; or
- Other situations where the tax authority finds evidence of underreporting income and the amount underreported is considered significant.

APAs

The MOF has provided detailed procedures and documentation requirements for an APA program that taxpayers may pursue. Taxpayers meeting certain criteria can apply to negotiate with the MOF for an APA. The application should be made in a prescribed format before the first accounting year-end of the controlled transactions to be covered in the APA. Generally, an APA would be valid for three to five years. Where a taxpayer's business nature has not materially changed, a one-time maximum five-year extension could be requested. However, there is no rollback provision in the APA program.

Effective date and impact

The TP Assessment Rules are effective from 30 December 2004. However, the penalty provisions and the requirement to prepare the Transfer Pricing Report are effective from the tax year 2005.

This means a taxpayer with a calendar year-end would have to:

- Complete the new disclosure forms regarding related party transactions when filing the 2004 and future tax returns;
- Prepare and maintain the required documentation, except for the Transfer Pricing Report, when filing the 2004 tax return; and
- When filing the 2005 and future tax returns, prepare and maintain all the required documentation, including the Transfer Pricing Report.

General Tax Update for Financial Institutions in Asia Pacific is issued for the information of clients and staff of KPMG and should not be used or relied upon as a substitute for detailed advice or as a basis for formulating business decisions. Materials published may only be reproduced with the consent of KPMG.

Contact us

Stephen Gottlieb
Australia
+61 2 9335 7122
sagottlieb@kpmg.com.au

Charles Kinsley
Hong Kong
+852 2826 8070
charles.kinsley@kpmg.com.hk

Naresh Makhijani
India
+91 22 2491 3131
nareshmakhijani@kpmg.com

James Dodds
Japan
+ 81 3 6229 8230
james.dodds@jp.kpmg.com

Shalet Marian
Malaysia
+60 3 2095 3388
shaletmarian@kpmg.com.my

Prakash Ramhotar
Mauritius
+230 207 8830
pramhotar@kpmg.intnet.mu

Brahma Sharma
New Zealand
+64 9 367 5816
bdsharma@kpmg.co.nz

Francisco Tagao
Philippines
+63 2 894 1833
fgtagao@kpmg.com.ph

Peter Kung
China
+852 2826 8080
peter.kung@kpmg.com.hk

Eng Meng Leong
Singapore
+65 6213 2417
meng@kpmg.com.sg

Lee Jae Won
South Korea
+82 2 2112 0955
jlee20@kr.kpmg.com

Premila Perera
Sri Lanka
+94 (0) 11 2426 501
premilaperera@kpmg.lk

Willis Yeh
Taiwan
+886 2 2715 9818
willisyeh@kpmg.com.tw

Kullakattimas Benjamas
Thailand
+66 2 677 2000
benjamas@kpmg.co.th

If you would like to subscribe for this publication, please contact Betty Lin on +852 2143 8510 or betty.lin@kpmg.com.hk of our Hong Kong office.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2005 KPMG, the Hong Kong member firm of KPMG International, a Swiss cooperative. All rights reserved. Printed in Hong Kong. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative.