General tax update for financial institutions in Asia Pacific

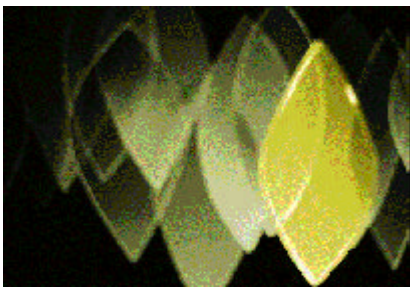
A KPMG HONG KONG TAX PUBLICATION

ISSUE 3 JANUARY 2003

Country

Hong Kong

Tax update



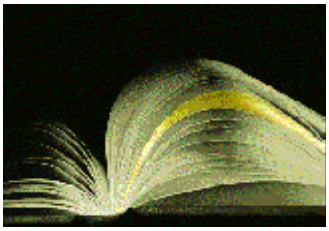
Court case

- In a recent decision, the High Court in Hong Kong held that an employee who received a housing benefit in the form of a rental refund was liable to pay tax on the full amount of the benefit as a cash allowance. The decision of the court has potentially broad significance for employers and employees in Hong Kong, as similar methods of "rental reimbursement" are used by many employers to provide remuneration tax effectively to their employees.

- Employer provided accommodation benefits from preferential tax treatment in Hong Kong, with the actual amount paid by the employer being ignored in the employee's Salaries Tax assessment and a notional benefit equal to 10% of the assessable income being added to income. Under the legislation the benefit can be provided either directly, with the employer entering into the lease agreement with the landlord, or indirectly, with the employee entering into the lease agreement and seeking reimbursement from his employer (rental reimbursement). A cash allowance, on the other hand, is fully assessable to tax. The recent case considered a rental reimbursement arrangement.

- In the case before the court, under the employment agreement the employee was entitled to a "housing benefit" determined by a scale according to pay scale points. The employment agreement provided that the employee was required to submit "*evidence for the actual payment they paid for housing*" to the employer. The employee spent the full amount of "housing benefit" on rent, rates and management fees, but the employer did not require documentary evidence to substantiate the amount paid. The "housing benefit" was paid monthly in arrears to the employee together with his monthly salary.

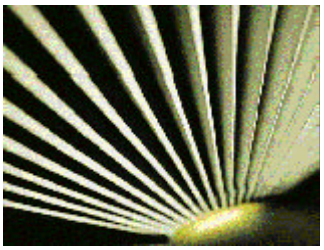
- The High Court found that as a matter of fact the employee was entitled to the amount of his remuneration designated as rental refund even if he did not spend it on rent – for example, it could be spent on other housing expenses, including mortgage interest which would not qualify for the beneficial tax treatment. Although the intention of the parties when entering into the employment agreement appeared to be to provide a housing benefit through "refunding" the employee's rental costs – the actual practice of the parties did not support the position. In reaching their decision, the court appears to have been influenced in part by the fact that the employee was not required to provide documentary evidence of the rent paid in respect of which he was being "refunded". Therefore, even though the employee spent the whole amount on rent, the nature of the benefit was more akin to a cash housing allowance, which is fully subject to tax, rather a rental refund.



Hong Kong (cont'd)

- The case raises a number of interesting issues. The court agreed (with the Board of Review – equivalent to a lower court) that the intention of the parties is the real test in deciding what the real nature of a payment is. However, they stated that the relevant point of time to determine this is not when the agreement was entered into but the time of payment of the money by the employer. The court also stated that the existence of a policy (or system of controls) was not required for a payment made to be regarded as rental refund – and, correspondingly, the existence of a policy did not necessarily mean that a payment was a rental refund.

India



Banking regulations

Scheme for setting up Offshore Banking Units in Special Economic Zones

- The Reserve Bank of India ("RBI"), the apex bank in India, has formulated and announced a scheme for setting up Offshore Banking Units ("OBUs") in Special Economic Zones ("SEZs") by banks (including foreign banks) operating in India.

- Some of the salient features of the scheme are:
  - Banks (Public/ Private/ Foreign) operating in India and authorised to deal in foreign exchange are eligible to set up OBUs. Banks having overseas branches and experience of OBUs are to be given preference. Each eligible bank would be permitted to establish only one OBU for carrying out wholesale banking operations.
  - Banks are required to obtain prior permission from RBI under section 23(1)(a) of the Banking Regulation Act 1949 as per licensing norms to be stipulated.
  - The parent bank should provide a minimum of US$ 10 million to its OBU.
  - OBUs are exempt from the Cash Reserve Ratio (CRR) requirements.
  - OBUs request for exemption to maintain the Statutory Liquidity Ratio ("SLR") for a specified period could be considered by RBI.
  - Sources for raising foreign currency funds should be external and sources from residents would be restricted to the extent residents are permitted to invest/ maintain foreign currency accounts abroad.
  - Deployment of funds would be restricted to lending to units located in SEZ and SEZ developers and foreign currency requirements of corporates in Domestic Tariff Areas.
  - All prudential norms applicable to overseas branches of Indian banks would be applicable to the OBUs.
  - OBUs should operate and maintain their balance sheet only in a foreign currency except for a rupee account to meet day-to-day expenses.

- OBUs would be prohibited from participating in domestic money market operations.

- OBUs are required to maintain separate Nostro accounts with correspondent banks.

Court case

Income tax

- *American Express International Banking Corporation vs. CIT [2002] 177 CTR 442 (Bom.)*

  - In the above case, the tax authorities considered the interest from the date of the last coupon date to the date of purchase of the security (broken period interest) as a part of the cost of such security and added it back to the total income of the assessee. However, they did not allow a corresponding deduction for the broken period interest paid at the time of sale of such securities.

  - The Mumbai High Court held that that was no reason for the tax authorities to deviate from the accounting treatment followed by the assessee and if the broken period interest of the assessee is taxed as business income, the tax authorities ought to allow a deduction for broken period interest paid by the assessee.

- *Raymond Ltd. vs. DCIT [ITA Nos. 1225 & 1226 / Mum / 2000 dated 24 April 2002] – Unreported*

  - In the above case, based on the provisions of the Double Taxation Avoidance Agreement between India and UK, the Income-tax Appellate Tribunal ("Tribunal") held that underwriting commission, selling commission and management commission paid to the lead manager abroad did not amount to 'Fees for technical services' and hence there was no obligation on the assessee to deduct tax at source.

  - In the aforesaid decision, the Tribunal laid down certain important observations:

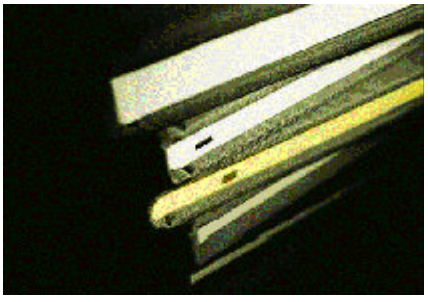
    - Even though the amount payable to the non-resident was allowed to be deducted from the sale proceeds of the GDR issue, the Tribunal held that the Company must be considered to have 'paid' the amount to the non-resident.

    - If the sum payable to a non-resident is fully chargeable to tax, undoubtedly, the tax has to be deducted at the appropriate rates on the whole of such sum.

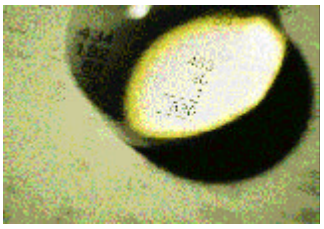
    - If only a part of the sum payable to the non-resident is chargeable to tax, an application should be made under section 195(2) to the tax officer for determination of the income embedded in such sum.

    - In case such an application is not filed, then the tax is to be deducted on the presumption that the whole sum is chargeable to tax.

    - Reimbursement of expenses could not be considered as taxable in India under section 9(1)(vii) as fees for technical services.



New Zealand



Changes in legislation

- The New Zealand government has released a discussion document on the GST treatment of financial services and the reverse charge. This proposes to allow business to business ("B2B") supplies[1] of financial services by a registered person to be zero-rated for GST purposes, while imposing a GST reverse charge on services provided from non-residents.

- However, B2B zero rating will not apply where the person receiving the supply has more than an incidental activity of making exempt supplies, such as financial services. The Government proposes defining "incidental activity of making exempt supplies" as 25% of total supplies made in a given twelve-month period.

- The impact of this change is that banks will be able to recover a much greater level of the GST they incur, as they will be eligible to claim GST on zero-rated supplies (which were previously treated as exempt). This will offset the cost of the reverse charge on the receipt of overseas services that is likely to be imposed at the same time.

- Further, the discussion document proposes to narrow the definition of "financial services" so that certain non-core financial services provided by third parties will be subject to GST. Thus, when a person, other than the person supplying the core financial service, has an involvement in the supply of that financial service, in the form of arranging, facilitating or executing the service, it is proposed that the service will now be subject to GST. This would include, for example, brokerage, life insurance commissions and other intermediary services provided by third parties.

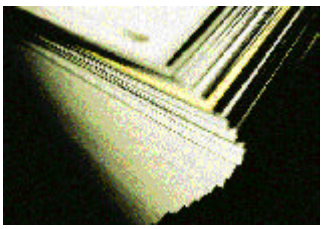
1 A B2B supply is one where financial services are supplied by one GST registered person to another GST registered person who is predominantly in the business of making taxable supplies, i.e. supplies that are subject to GST.

PRC

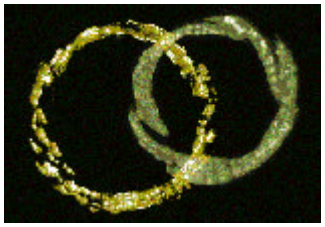
Changes in legislation

- The China Securities Regulation Commission and PBOC jointly issued Decree No. 12, the Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (QFII), which came into effect on 1 December 2002. The regulation sets out the requirements for foreign institutional investors to be qualified in investing in PRC domestic securities markets.

- The Ministry of Finance and the State Administration of Taxation has jointly issued Cai Shui (2002) No. 182 concerning business tax on overdue interest for financial institutions ("FIs"). The notice came into effect on 1 January 2003 and brings business tax into align with PRC financial and accounting rules. FIs will now only be required to pay business tax for overdue accrued interest for up to 90 days as opposed to 180 days.



Sri Lanka



Changes in legislation

Fiscal Proposals 2003 (i.e. pending legislation) presented on 6 November 2002 are as follows:

- Overall reduction of corporate rate of tax from 35% to 30% with effect from year of assessment 2003/2004. 50% of savings due to the reduction to be contributed to a Human Resource Endowment Fund to be set up by the Government.

- Tax of 10% on remittances of profit, effective year of assessment 2003/2004. Currently, tax is 33-1/3% of the remittance but limited by reference to 1/9th of taxable income in the year of remittance.

- 10% VAT on banks and other financial institutions to be levied from 1 January 2003. The proposed base for application is accounting profit plus employee remuneration. No input credit.

- Preclusion on set-off of losses against profits from other activities of the same entity/ person.

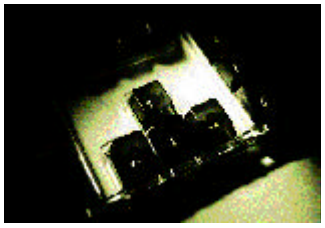
- Offshore dividends to be subject to a maximum tax of 10%.

- Extension of the 0.1% debits tax on current accounts to cover savings accounts as well.

Court case

- In terms of a recent Supreme Court decision (P. D. Rodrigo vs. CGIR) it was held that where the appellant's firm had only one indivisible business, there was only one source of income with a sub source. The services rendered and the facilities used could not be divided into two separate categories except for the direct expenses clearly identifiable in relation to the sub source. This would be of relevance where the sub source is exempt from income tax or entitled to concessionary rate taxation.

Taiwan



Changes in legislation

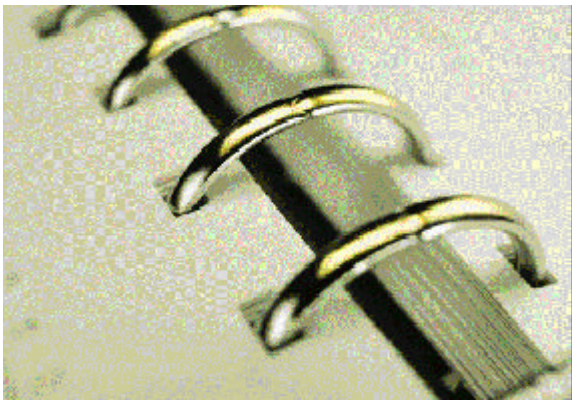
Proposals to amend or eliminate the 10% surtax on undistributed earnings:

- On 30 October 2002, the Department of Taxation and the Ministry of Finance presented several proposals to the Finance Reform Committee under the Executive Yuan in respect of amending or eliminating the 10% surtax on undistributed earnings.

  Several alternatives and options (as summarized below) have been considered and proposed by the Department of Taxation.

Alternative 1 – to equalize the corporate and top individual income tax rates and eliminate the 10% surtax:

Taiwan (cont'd)



Option A: - increase corporate income tax rate from 25% to 35%
- reduce top individual income tax rate from 40% to 35%

Option B: - increase corporate income tax rate from 25% to 30%
- reduce top individual income tax rate from 40% to 30%

Alternative 2 – to narrow the gap between corporate and top individual income tax rates and eliminate the 10% surtax:

- increase corporate income tax rate from 25% to 30%

Alternative 3 – to equalize the corporate and top individual income tax rates, eliminate the 10% surtax, and reduce/ eliminate tax concessions:

Option A:
- increase corporate income tax rate from 25% to 30% and have a minimum tax rate of 5% for all companies, including those enjoying tax concessions
- reduce top individual income tax rate from 40% to 30%

Option B:
- increase corporate income tax rate from 25% to 30% and eliminate all tax concessions
- reduce top individual income tax rate from 40% to 30%

Enactment of the "Local Tax Law"

- The Legislative Yuan enacted a new law, the "Local Tax Law" on 19 November 2002 authorizing local governments through the local legislative process to impose Temporary Taxes for no longer than two years or Special Taxes for no longer than four years. In addition, the law allows local governments to increase the tax rates for both local taxes (excluding stamp duties and land value incremental tax) and national taxes (excluding customs duty, commodity tax and VAT) by up to 30% of the existing rates for no longer than four years.

- The purpose of the law is to allow local governments to raise income by themselves thereby reducing their reliance on income allocations from the central government. The Commissioners of various counties plan to tax internet cafes, computer game businesses, power plants and for the Taoyuan county, to introduce airport tax. However, local governments are prohibited from taxing:
  - transactions occurring outside its territory;
  - natural resources or mineral products traded outside their territory;
  - public utilities whose business scope is cross territory; or
  - items that are detrimental to the overall national interest or other local public interest.

Taiwan (cont'd)

- In addition, the local governments are prohibited from raising Special taxes on the same tax base as Commodity Tax and Liquor and Tobacco Taxes.

- As the new law has been passed by the Legislative Yuan, as soon as the president signs and promulgates the new law, it will be up to the local governments to enact the new taxes based their own needs through the local legislative process. Taxpayers are strongly advised to follow local government proposals closely to monitor the possible introduction of new taxes or any increase in existing tax rates.

Thailand

Changes in legislation

Withholding tax on swap payments

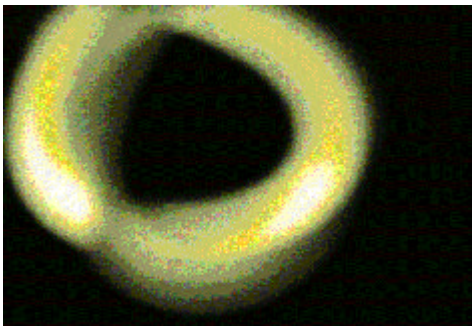
- The Revenue Department issued a new instruction to set out their revised position regarding swaps. This instruction repeals all previous regulations, orders, instructions, rulings or guidelines that are contrary to the new instruction.

- In summary, the instruction provides that swap payments shall be deemed income under Section 40(8) of the Revenue Code and not subject to withholding tax under Section 70 unless the swap counter-party is the lender of the hedged loan, in which case the payments shall be deemed income under Section 40(4)(a) of the Revenue Code (and subject to withholding tax).

Recognition of interest income for credit card business

- The Revenue Department has introduced new rules for corporate tax purposes for recognising interest income derived by a credit card business.

- Where interest revenues have been in default for more than six consecutive months, a credit card business operator may record interest revenues thereafter as revenue in the accounting period in which payment is received. The adoption of the cash basis is subject to the following conditions:
  - Expectations are certain that no payment can be received; and
  - It is clear that the debtor does not have enough money or property to settle the debt.



- These rules can be applied where the interest recognition rules for banking, finance, securities and credit foncier[2] businesses do not otherwise apply.

- The new rules will apply to accounting periods ending on or after 31 December 2002 onwards.

2 A credit foncier carries on the business of lending money on the security of a mortgage of immovable property.

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