General tax update for financial institutions in Asia Pacific

A KPMG HONG KONG TAX PUBLICATION

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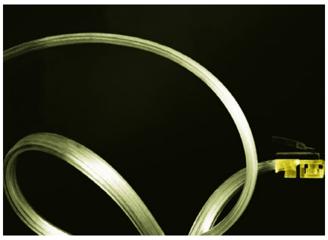
Country

Australia



Tax update

Change in legislation

- On 19 February 2004, Tax Laws Amendment (2004 Measures No. 1) Bill 2004 was introduced into the House of Representatives. This Bill makes amendments to the income tax law and other laws to give effect to the following taxation measures:
  - insert certain integrity rules dealing with payments, loans and forgiven debts made by a trustee to a private company's shareholder or a shareholder's associate;
  - ensure that GST, which may later be recovered, does not count as part of the cost of an asset, when calculating capital gains tax; and
  - provide a tax deduction for contributions of cash or property to deductible gift recipients, where an associated minor benefit is received.

- On 10 March 2004, taxation ruling TR 2004/2 was released. This Ruling provides that expenses incurred either by a head company of a consolidatable or consolidated group or an entity that may become a subsidiary member of a consolidated group in obtaining a market valuation for consolidation, are not deductible under general Australian income tax principles. The expenses are neither an outgoing incurred in gaining or producing assessable income or as a loss or outgoing necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. However, the expenditure may be deductible under specific legislation relating to managing one's tax affairs.

- On 23 March 2004, Taxation Laws Amendment Bill (No. 2) 2004 received royal assent. This legislation is primarily concerned with:
  - Consolidation – the revocation of certain choices and research and development (R&D) tax offset; and
  - Changes to value shifting rules – intended to reduce compliance costs on the transition to consolidation.

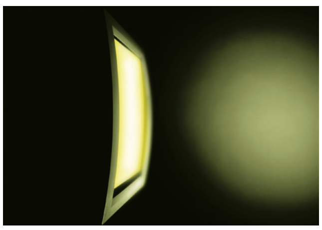
- On 30 March 2004, The Joint Liberal and National Party meeting in Canberra cleared the Tax Laws Amendment (2004 Measures No. 2) Bill for introduction into the Federal Parliament. This Bill is expected to contain several changes relating to the consolidation provisions.

- On 1 April 2004, the New International Arrangements (Participation Exemption and Other Measures) Bill 2004 was released. This bill represents the most significant change in Australia's international tax regime in the last 15 years and a major shift in policy:
  - All active foreign income will be exempt:
    - Non-portfolio (more than 10% holding) dividends;
    - Active foreign branch income.
  - New capital gains tax exemption for gains on disposal of non-portfolio interests (more than 10% holding) in foreign companies with underlying active businesses.
  - Related party service income no longer taxable.
- On 7 April 2004, the Minister for Revenue and Assistant Treasurer, Senator Helen Coonan, released a package of measures that are intended to substantially simplify the company loss recoupment rules. Broadly, the media release provides that while the underlying structure of the loss recoupment rules will remain, a simplified Continuity of Ownership ("COT") test will be provided for all widely held companies and a broader range of subsidiary companies. In addition, the simplified COT will replace the Same Business Test for large companies and large consolidated groups.
- On 15 April 2004, The Treasurer, Mr Peter Costello, announced that as part of the Review of International Taxation Arrangements that the Government will pare back the classes of tainted income treated as eligible designated concession income. This involves altering regulations to replace general categories with a revised specific list of income. As a result, only specific items of income which pose significant integrity risks will be designated concession income subject to attribution. This more targeted approach is intended to reduce the informational requirements and compliance costs business face in applying the controlled foreign companies ("CFC") rules where broad exemption listed country CFC's are involved.

<u>Court case</u>

On 9 March 2003, the decision handed down by the Full Federal Court in *Sun Alliance Investments Pty Ltd (In Liq) v Commissioner of Taxation*, held that unrealised pre-merger profits were to be included in calculating the "rebatable dividend adjustment" for the purposes of determining the reduced cost base of shares under section 160ZK of the Income Tax Assessment Act 1936 (ITAA 1936).

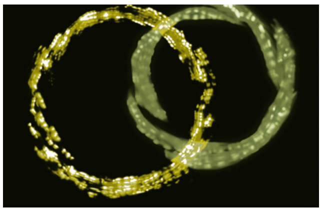
Hong Kong



The Financial Secretary delivered the 2004/05 Budget Speech to the Legislative Council on 10 March 2004. No increase in the profits tax rate was proposed, however, in line with measures introduced in 2003, the standard rate for salaries tax was increased by 0.5% to 16%.

For details of the 2004/05 Budget, please visit <u>http://www.kpmg.com.hk/pub.htm?id=747</u>

Indonesia



Tax treaty with China in effect

The tax treaty between Indonesia and China has been ratified and is effective 1 January 2004. The pertinent withholding tax and PE time tests are:

- Dividends: 10% (no minimal shareholding criteria)
- Interest: 10% (exempt where paid to the Chinese government or specified authority)
- Royalties: 10%
- Branch profits: 10%
- PE time test 6 months

Also:

- Gains from the sale of unlisted shares in an Indonesian company are exempt from Indonesian tax unless assets of company principally immovable property in Indonesia
- International shipping – Indonesian source income – tax reduced by 50%
- Operation of aircraft in international traffic taxable only in country of residence of operating company

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Japan

US-Japan tax treaty

The governments of the United States and Japan exchanged instruments of ratification at a March 30th ceremony in Tokyo. Thus, the new income tax treaty (which replaces a 1971 income tax treaty) has entered into force.

The provisions of the new tax treaty related to source-country withholding taxes are applicable beginning on 1 July 2004. The provisions related to other taxes generally are applicable for tax years beginning on or after 1 January 2005. A person entitled to greater benefits under the prior tax treaty may elect to continue to apply the terms of the prior tax treaty in its entirety for an additional period of 12 months from the date on which the provisions of the new tax treaty would otherwise have effect. Because the new tax treaty entered into force before 1 April 2004, reductions in withholding taxes will apply as of 1 July 2004.

<u>Recent tax assessment case</u>

In the past, the treatment of limited partnerships has been uncertain but the tendency was to treat them as transparent. However, it has been reported that the Nagoya Regional Taxation Bureau recently issued a tax assessment in which they concluded that a US limited partnership is a business entity that can own assets, has its name registered legally and stands as a party in court proceedings. The Nagoya Regional Taxation Bureau therefore concluded that it follows that the limited partnership is a corporation for Japanese tax purposes. The taxpayer in the current case has appealed against the assessment.

It is expected that the tax authorities will issue comprehensive guidance in the next couple of years to clarify the tax treatment of various types of foreign legal entity.

Mauritius

Change in legislation

At present, interest receivable in any income year by an individual personally or as an associate in a societe (partnership) or as a beneficiary in the estate of a deceased person is exempt up to a certain amount on:

(i) Government securities;

(ii) bills issued by the Mauritius Civil Service Mutual Aid Association Ltd; or

(iii) fixed deposit or savings accounts in Mauritius with a bank or other institution authorised by any other enactment to accept money on fixed deposit or savings accounts and to pay interest on it in Mauritius.

There has now been a change to include interest on Bank of Mauritius Bills issued under the Bank of Mauritius Act to the above as item (iv). This change was brought in on 20 February 2004 but is effective as from 1 July 2003.

New Zealand

As mentioned in the last update, an issue paper was released to the New Zealand Bankers Association ("NZBA") and other registered banks regarding potential changes to the conduit and thin capitalization rules. For details, please refer to the last tax update: http://www.kpmg.com.hk/pub.htm?id=753

The NZBA sent a response to this paper, and the New Zealand Inland Revenue has returned with a new paper that proposes a different measurement relating to thin capitalization for banks. Broadly, the revised proposals relating to thin capitalization would require the measurement of a ratio of New Zealand equity to risk weighted exposures in New Zealand, using regulatory concepts where possible.

The NZBA is currently considering these proposals.

Phillipines

On 15 March 2004, Republic Act No. 9243, an act rationalizing the provisions on the Documentary Stamp Tax ("DST") of the National Internal Revenue Code of 1997, took effect. Under the said legislation, the stamp tax on every original issue of debt instruments has been increased from P0.30 on each P200.00 of the face value of the agreement to Pl.00 on each P200.00 or fraction part thereof.

For such debt instruments with terms of less than 1 year, the DST to be collected shall be of a proportional amount in accordance with the ratio of its term in the number of days to 365 days, provided that only one DST shall be imposed on either the loan agreement, or the promissory notes issued to secure such loan.

The term debt instrument shall mean instruments representing borrowing and lending transactions including but not limited to debentures, certificate of indebtedness, due bills, bonds, loan agreements, including those signed abroad wherein the object of 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 deposit that are either drawing interest significantly higher than the regular savings deposit taking into consideration the size of the deposit and the risks involved or drawing interest and having a specific maturity date, orders for payment of any sum of money otherwise than at sight or on demand, promissory notes, whether negotiable or non-negotiable, except bank notes issued for circulation.

On the other hand, among those not subject to the documentary stamp tax are the following:

- Borrowing and lending of securities executed under the Securities Borrowing and Lending Program of a registered exchange, or in accordance with regulations prescribed by the appropriate regulatory authority, provided that any borrowing or lending of securities agreement as contemplated hereof shall be duly covered by a master securities borrowing and lending agreement acceptable to the appropriate regulatory authority, and which agreement is duly registered and approved by the Bureau of Internal Revenue.

- Loan agreements or promissory notes, the aggregate of which does not exceed P250.000.00, or any such amount as may be determined by the Secretary of Finance, executed by an individual for his purchase on installment for his personal use or that of his family and not for business or resale, barter or hire of a house, lot, motor vehicle, appliance or furniture. The amount to be set by the Secretary of Finance shall be in accordance with a relevant price index but is not to exceed 10% of the current amount and shall remain in force at least for 3 years.

- Assignment or transfer of any mortgage, lease or policy of insurance, or the renewal or continuance of any agreement, contract, charter, or any evidence of obligation or indebtedness, if there is no change in the maturity date or remaining period of coverage from that of the original instrument.

- Fixed income and other securities traded in the secondary market or through an exchange.

- Derivatives, provided that repurchase agreements and reverse repurchase agreements shall be treated similarly as derivatives.

- All forbearances arising from sole or service contracts including credit card and trade receivables, provided that the exemption shall be limited to those executed by the seller or service provider itself.

- Bank deposit accounts without a fixed term or maturity.

- All contracts, deeds, documents and transactions related to the business of the Bangko Sentral ng Pilipinas.

- Interbank call loans with a maturity of not more than 7 days to cover any deficiency in reserves against deposit liabilities including those between or among banks and quasibanks.

Singapore

Secondary loan trading

It was announced in the 2004 Budget Speech that secondary loan trading would be included in the Financial Sector Incentive Scheme ("FSI"). According to the Monetary Authority of Singapore ("MAS"), the activity would be included under the FSI Standard-Tier Award that qualify for the 10% concessionary tax rate. Details will be provided by the MAS in due course.

Approved Commodity Derivatives Trader ("CDTs") Tax Incentive

Approved CDTs would be subject to tax at the concessionary rate of 5% on income derived from a) trading in commodity derivatives and physical commodities (ie. spot or forward basis); b) intermediary services in connection with commodity derivative transactions, with specified persons. Commodity derivatives refer to derivatives that are transacted over-the-counter whose payoffs are linked, in whole or in part, to the payoffs or performance of underlying commodities. The incentive will be awarded for a period of 5 years.

Processing Services Tax Incentive

It was proposed in the 2004 Budget Speech that qualifying income derived from approved companies from the provision of high value-added processing services (eg. swap clearing) to financial institutions would be subject to tax at the concessionary rate of 5% or 10% (to be determined by MAS in due course). More details will also be provided by MAS in due course.

Asset Securitization

It was announced in the 2004 Budget Speech that a concessionary tax treatment will be introduced to address and mitigate the tax disadvantages for special purpose vehicles engaged in asset securitization activities. Currently, there is no special tax rule regarding special purpose vehicles set up for asset securitization purposes. One of the disadvantages relate to the mismatch in timing between receipt of income and payment of expenses. More details will be released by the Inland Revenue Authority of Singapore in due course.

Taiwan

Designated trust fund with investment in foreign securities

The Ministry of Finance ("MOF") issued a tax ruling on 4 February 2004 stating that with respect to the income derived from a "designated trust fund with investment in foreign securities", instead of following the procedures outlined under ruling no. 910456205, the trustee shall follow the reporting procedures under Article 92-1 of Taiwan Income Tax Law. This ruling should apply from 2005 when reporting the 2004 income derived from such trust fund.

According to Article 92-1 of Taiwan Income Tax Law, the trustee shall, prior to the end of January of each year, prepare, in a prescribed format, and submit the property list of the trust, the revenue and expenditure statements, the statement of trust benefits accrued and payable to trust beneficiaries as calculated according to Article 3-4 of this law, and the withholding tax related documents as required under Article 89-1 of this law. In addition, the trustee shall issue, prior to the 10th day of February, the withholding certificates or non-withholding certificates and relevant certificates to tax payers.

"Deemed Interest" on Offset Home Mortgage – announced by the National Tax Office ("NTO") and MOF

In the past 2 years, Offset Home Mortgage ("mortgage") products have become very popular in the Taiwan market. The feature of such Offset Home Mortgage is that once a mortgage is granted, the borrower is required to open a savings account with the same bank. The benefit of this product is that the interest on the mortgage will only be calculated on the net balance of the mortgage and the savings account. For example, Borrower A was granted a mortgage of NT$10MM with an interest rate of 5%. At the same time Borrower A has NT$2MM in the savings account. The interest on the mortgage will be calculated as below –

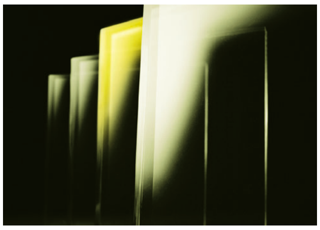
Interest = (NT$10MM – NT$2MM) * 5%
= NT$0.4MM

An important feature of the mortgage contracts is that they specifically state that "no interest will be calculated on the savings account balance".

Position Taken by the NTO and the MOF

Currently, the NTO and the tax department of the MOF take the position that even though it is agreed no interest will be calculated on the savings account balance, the borrower in substance had used the interest on the savings accounts to pay off the interest on the mortgage. As such, using the above example, even though the borrower only pays NT$0.4MM of interest on the mortgage, the MOF deemed interest to be received on the savings balance using the interest rate for the mortgage; under the above example the deemed interest will be calculated as NT$0. 1MM i.e. NT$2MM * 5%.

The MOF has also advised that banks who sell these products should issue "Withholding Tax Certificates" for the "deemed" interest income of NT$0.1MM to the borrower. The borrower should report such interest income in his/her individual income tax return. On the other hand, banks, being the statutory withholding tax agents, should withhold tax on such interest, report and pay the withheld tax to the tax authority and issue a withholding tax certificate to the



borrower. Banks who do not perform the above obligations will need to pay the under-withheld amount to the tax authority and will be subject to penalties equal to 1 to 3 times the under-withheld amount if it is detected by the tax authority.

The MOF has requested a list of banks that have offset home mortgage products from the Monetary Bureau.

KPMG Comments

Under this decision, the NTO and the MOF ignored the specific term, “no interest is calculated on the savings account balance”, agreed and signed by both parties. Further, the NTO and MOF overlooked the fact that the mortgage should be treated as a credit limit given by the banks to the borrowers and the savings account balance should be considered as repayment of the mortgage; thus affecting the mortgage balance. One other point to be noted is that the MOF deemed the interest rate on the savings account to be the mortgage interest rate where in fact the interest on savings accounts in the market is much lower than the mortgage interest rate.

This decision will greatly affect the mortgage market and the recently recovered real estate market. However, banks should also review their practice to comply with the new tax ruling issued by the MOF. At the same time, efforts from all banks are needed to further discuss this with the MOF.

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