Asia Pacific **Real Estate Funds** Briefing

July 2013

This newsletter continues our series of updates on tax issues affecting real estate funds investing in Asia.

The continued expansion of anti-avoidance rules continues to be the central theme, with Australia seeking to tighten its rules in light of recent court rulings, while India continues to push forward with its General Anti-Avoidance Rule (GAAR), although with some relaxation in response to concerns raised by taxpayers. New Zealand and Australia have both tightened their thin capitalisation rules and China has published further guidance on Circular 601. Investors will need to be mindful of these changes when they structure investments.

India

India Budget 2013 – General Anti-Avoidance Rules

As noted in [KPMG's Asia Pacific Real Estate Funds Briefing - October 2012](), the Indian Government has formed a committee to consult with stakeholders regarding the GAAR. Based on the committee's recommendations, the Indian Government has proposed modifying the GAAR provisions in its Finance Bill 2013. The key modifications include the following:

- The GAAR provisions will be effective from the financial year 2015–2016 (instead of the financial year 2013–2014).
- Only arrangements with the main purpose (and not one of the main purposes) of obtaining a tax benefit will be covered.
- Factors such as the timeline of the arrangement, the payment of taxes (directly or indirectly) and the exit route will be relevant but insufficient for invoking the GAAR provisions.
- An arrangement will be deemed to lack 'commercial substance' if it has no significant impact on business risks or net cash flows.

Detailed guidelines regarding the implementation of the GAAR provisions have not yet been published. Until such guidelines are revealed, real estate funds face uncertainty and need to consider a range of interpretations of the revised GAAR provisions as they evaluate their investment strategies in India.

Other key proposals in the India Budget 2013

Another important proposal is that unlisted Indian companies will be subject to an additional income tax at 20 percent on 'distributed income' paid to shareholders by way of a buy-back of their own shares. 'Distributed income' refers to the consideration of buy-back reduced by the issue price of these shares. The tax will be similar to dividend distribution tax, and any income in the hands of the shareholders in respect of the buy-back will be tax exempt. This amendment is effective from 1 June 2013.

The proposal also clarifies the requirement for foreign investors to obtain a tax residency certificate (TRC). In particular, it states that the TRC no longer needs to be in a prescribed format and the presentation of a TRC endorsed by the contracting party is sufficient for the purpose of claiming tax treaty benefits.

Committee's recommendations in relation to taxation of indirect transfers

As set out in KPMG's Asia Pacific Real Estate Funds Briefing - May 2012, the 2012 Finance Act contains a retrospective amendment to include 'indirect transfers' within the ambit of taxable transactions in India. To address foreign investors' concerns around the application of the amendment, the Indian Government has set up a committee to collate feedback from stakeholders and finalise the relevant guidelines.

In the draft report, the committee has recommended carving out genuine transactions and the restriction of these provisions to sham and tax avoidance transactions. The committee also suggests that the amendments should apply prospectively and seeks to clarify the interpretation of certain key terms in the provision.

These recommendations are being evaluated and if accepted by the Indian Government, would remove some uncertainties surrounding the taxation of indirect transfers.

Introduction of the Companies Bill 2012

The 2012 Companies Bill has been submitted to the Upper House of Parliament for approval and could impact how investments in India are structured and financed going forward.

If the bill is enacted in its current draft, private Indian companies will be able to issue equity shares with differential rights, which would allow greater flexibility in terms of profit repatriation. In addition, Indian companies would be allowed to make dividend distributions even in the event of a loss in that year. This would mitigate the risk of cash traps in Indian special purpose vehicles (SPV) and could allow foreign investors to reduce their debt-to-equity ratio, particularly in view of the complications around regulations on debt financing in India. The relaxation regarding the distribution of dividends will also be a welcome move for real estate funds which rely on the repatriation of profits through the buy-back of shares, which must have a gap of one year (whether through board or shareholder approval) under the 2012 bill.

While the bill has not been enacted, the changes with respect to the form and manner of the provisions should be considered when structuring investments in Indian real estate assets.

Rationalisation of regulations on offshore investment in debt instruments of Indian companies

In March 2013, the Indian Government rationalised the foreign investment policy on Indian debt papers. The current auction mechanism of allocating debt limits will be replaced by the 'on tap' system currently in place for infrastructure companies, and debt instruments of all companies can be directly acquired by foreign investors. Each Indian company may offer up to USD 51 billion of corporate debt instruments to qualified foreign investors, of which up to USD 3.5 billion worth of commercial papers can be included.

Once the aggregate amount of debt instruments issued to foreign investors reaches 90 percent of the relevant limits, the auction mechanism will be initiated for allocating the remaining amounts.

This relaxation is expected to bring a significant boost to the Indian real estate industry, as the majority of overseas investments in this industry are through debt instruments.

Hong Kong

Scope of offshore funds exemption extended

In the 2013–14 budget speech in March 2013, Financial Secretary John Tsang announced that the offshore funds exemption will be extended to include transactions in private companies incorporated or registered outside Hong Kong and which do not hold any Hong Kong properties or carry on business in Hong Kong.

This is a welcome move, which should help the Hong Kong private equity real estate market remain competitive with other key jurisdictions such as Singapore.

The changes should help to enable non-resident investors investing in real estate outside Hong Kong through SPVs to have their investments managed in Hong Kong without the risk of any gains arising on disposal falling within the Hong Kong tax net. This will potentially help fund managers deal with many of the current commercial difficulties that can arise as a result of the need to take key decisions offshore. Investors and fund vehicles will need to meet the other requirements of the offshore funds exemption to qualify.

The matter will be put up for consultation, and as currently proposed, there are a few potential concerns with the proposals:

1. The Government may risk leaving investors with a choice between either trying to obtain treaty benefits or seeking to use the offshore funds exemption. In most cases, the ability to access treaty rates of Withholding Tax or to take advantage of the allocation of taxing rights under the capital gains clause is dependent on being resident in Hong Kong. Treaty partners are also increasingly looking for Hong Kong companies to demonstrate substance and/or commercial purpose before granting any treaty benefits. Corporations qualified for the offshore funds exemption are therefore unlikely to enjoy the treaty benefits provided to Hong Kong residents.

2. The terms of the offshore fund exemption prevent it from applying in cases where the underlying investment is in Hong Kong property. This means that pan Asian or global funds with interests in Hong Kong would need to be very careful about relying on the exemption, as any investment activity in Hong Kong could result in the entire fund falling outside the exemption.

3. The offshore fund exemption only applies to investments managed by a regulated entity in Hong Kong. The compliance costs may

therefore be high depending on the form of registration required.

The details of the reforms have not yet been set out, and as noted above, they are subject to consultation.

Further stamp duty measures to curb 'exuberant' property transactions

The Hong Kong Government announced on 22 February 2013 that the Ad Valorem Stamp Duty on both residential and non-residential properties will be doubled from 4.25 percent to 8.50 percent for all property types. The timing of when stamp duty is payable for non-residential properties has also been brought forward to the date when the provisional contract is signed. These moves are intended to further curb property prices in Hong Kong by increasing transaction costs, to align the stamp duty regime for both residential and non-residential properties and to forestall any possible shift from the residential market to the non-residential market. The proposed measures were gazetted on 26 April 2013 and took effect from 23 February 2013. An exemption from the new stamp duty rates will be given to Hong Kong permanent residents (HKPRs) who are either first-time home buyers, who do not own their own homes or who buy a flat and sell their old one within six months.

These measures follow on from the Government's introduction of a Buyer's Stamp Duty (BSD) on 26 October 2012. BSD at a flat rate of 15 percent is imposed on residential properties acquired by companies and persons who are not HKPRs. BSD is charged in addition to the existing Ad Valorem Stamp Duty and Special Stamp Duty (SSD) if applicable (please refer to KPMG's Asia Pacific Real Estate Funds Briefing - September 2011 for details).

BSD represents a real cost to institutional investors that acquire residential property in Hong Kong through SPVs, regardless of whether they are controlled by or have any shareholders or directors who are HKPRs. Real estate funds with redevelopment projects should, however, note that the acquisition of residential properties for the construction of a new building is entitled to a refund of BSD. As with stamp duty and SSD, exemptions will also be provided for the sale or transfer of a residential property within a corporate group, and BSD paid by a seller as a business expense may be treated as deductible for Profits Tax purposes.

In addition, the bill proposed adjustments to the duty rates and holding period in respect of SSD (please see table below). These measures were gazetted in December 2012 and took effect from 27 October 2012.

While the number of property transactions plunged following the announcement in February 2013, it remains to be seen what impact these additional measures will have on property prices in the long run, and developments in this area will continue to be watched with interest.

Holding period	Current SSD rate	Proposed SSD rate
Less than 6 months	15%	20%
6 to 12 months	10%	15%
12 to 24 months	5%	10%
24 to 36 months	0%	10%

Australia

2013–2014 Federal Budget – tightening of the Australian thin capitalisation rules

As part of its 2013–2014 Federal Budget, the Australian Government issued a proposal paper on 14 May 2013 announcing significant changes to the Australian thin capitalisation rules that will limit deductions for interest expenses.

The proposed changes include:

- Reducing the current 75 percent gearing limit safe harbour to a 60 percent gearing limit for general entities (i.e. from 3:1 to 1.5:1 debt to equity gearing ratio)
- Reducing the worldwide gearing ratio for general entities and non-bank financial entities from 120 percent to 100 percent, and extending the worldwide gearing test to inbound investors
- Increasing the de minimis threshold before thin capitalisation applies from AUD 250,000 to AUD 2 million of debt deductions.

The arm's-length debt test remains available and the Board of Taxation will review the test to consider ways to improve its operation.

Most entities have 13 months to transition, as the proposed commencement date is 1 July 2014.

In light of the above changes, potential considerations for investors include:

- Considering alternative tests for determining the maximum allowable debt under the thin capitalisation rules such as the arm's length debt test
- Reconsidering the existing mix of debt and equity funding for investments
- Revaluing certain assets for thin capitalisation and accounting purposes.

2013–2014 Federal Budget – non-resident withholding tax for direct disposal of Australian real property

The Australian Government also announced in its Federal Budget that it will introduce a non-final 10 percent withholding tax (WHT) from 1 July 2016 on the gross proceeds on the disposal of any taxable Australian property over AUD 2.5 million by a foreign resident. Further consultation will occur on this measure.

The proposed WHT represents a cash flow timing issue rather than any change in the effective tax rate on disposal

Capital gains tax (CGT) exemptions for indirect investments in Australian property by non-residents have been limited. Generally, non-residents are not subject to CGT on a sale of shares in an Australian company unless it is land-rich. The proposed changes are intended to increase the number of instances where companies will qualify as land-rich by requiring intercompany loans to be disregarded (under the current rules, intercompany loans count as non-land assets and can reduce a company's land-rich percentage).

Proposed amendments to the general anti-avoidance provisions

On 13 February 2013, the proposed amendments to the general anti-avoidance provisions under Part IVA of the tax legislation ('Part IVA') were introduced to Parliament by the Australian Government. The proposed amendments, if legislated as they are currently drafted, will have a considerable impact on how taxpayers and the Australian Taxation Office (ATO) approach the potential application of Part IVA going forward.

Broadly, Part IVA applies when a taxpayer enters into a scheme for the sole or dominant purpose of obtaining a tax benefit. The three pillars upon which Part IVA is based on are the concepts of 'scheme',

'tax benefit' and 'dominant purpose', and all three must be satisfied in a transaction for the application of Part IVA.

Recent court decisions have raised concerns for the Australian Government that many transactions would fall outside the operation of Part IVA on the basis that the taxpayer could argue that there was no tax benefit, as the most reasonable alternative postulate is that they would have done nothing.

In essence, the proposed changes to Part IVA aim to strengthen Australia's approach to tax avoidance by ensuring that:

- the dominant purpose test becomes the decisive factor (that is, the fulcrum)
- a tax benefit would require the identification of a positive alternative (that is, the 'do nothing' argument can no longer be used).

Ultimately, there will be uncertainty regarding how these amendments will affect the operation of Part IVA until they are considered by the ATO and the courts. If enacted, the new rules will apply retrospectively to arrangements entered into on or after 16 November 2012.

As a result of these proposed amendments, when considering entering into a transaction, taxpayers should ensure they have the proper and contemporaneous documentation of the commercial drivers, as well as the purpose of a transaction; and they should consider potential alternatives to the transaction and commercial reasons for disregarding the alternatives.

The changes proposed above should be considered when structuring investments in Australian real estate assets.

Foreign pension fund access to the Australian Managed Investment Trust (MIT) regime

As discussed in the Asia Pacific Real Estate Funds Briefing October 2012 issue, the ATO issued ATO Interpretative Decision ATO ID 2012/71 on 24 August 2012, which states that a foreign pension fund that holds an indirect interest in an MIT via an interposed trust will not be eligible for the concessional WHT rate under the Australian MIT regime. This is on the basis that the foreign entities are trusts.

Following the above, the Australian Government announced on 13 February 2013 that it will amend the tax legislation to ensure foreign pension funds can access the MIT WHT regime and will not be taxed at the punitive rate of 45 percent.

The amendments are intended to apply retrospectively to the start of the MIT regime on 1 July 2008.

However, there has been no mention of this proposed amendment applying to foreign trusts, which are not pension funds. Therefore, considerable uncertainty remains for these MIT investors due to ATO ID 2012/71. MITs will need to consider whether the announcements made by the Australian Government provide sufficient comfort to deduct MIT WHT from their distributions to non-resident trust investors at the 15 percent or 30 percent rate. If it is not considered sufficient, MITs may commence deducting at a rate of 45 percent from distributions to non-resident trust investors and other non-trust investors where the status of those investors has not been verified.

Notwithstanding the above, MITs can gain some comfort from the Australian Government's announcement that further consultation will be held with the industry to ensure that the MIT regime operates as intended and in line with current market practice.

China

VAT reforms in the construction and real estate sectors

The first stage of the value added tax (VAT) pilot program for the modern services and transportation sectors has been implemented in many of the major commercial centres across China, and attention is now turning to those industries which are yet to transition from Business Tax (BT) to VAT.

It is widely speculated that the construction and real estate sectors will be among the next sectors to transition, probably in early 2014. The Chinese Government has announced that construction services will be subject to VAT at the rate of 11 percent, and it is widely assumed that the real estate sector will be allocated a similar rate.

If the implementation for the construction and real estate sectors follows the format to date, no VAT refund will be allowed and it will be necessary to offset VAT on construction against future output VAT liabilities.

Based on previous experience, it is likely that the changes will be introduced quickly, with few transitional relief options. Real estate investors should start considering the impact of the changes in terms of future cash flow modelling and the flexibility of rental agreements.

Clarifications on beneficial ownership of dividends under tax treaty

The State Administration of Taxation's (SAT) Shuizonghan [2013] No. 165 ('Circular 165') issued in April 2013, has clarified the application and interpretation of various provisions in relation to 'adverse factors' under Circular 601, which could affect foreign investors' eligibility to enjoy reduced WHT on China-sourced dividend income under double taxation agreements (DTA).

Although Circular 165 aims to address enquiries from local SAT offices on certain Hong Kong companies' status as the beneficial owners of China-sourced dividends, the guidance is expected to be followed by all tax authorities in China and applied to China's other DTAs, with dividend articles worded similarly to that with Hong Kong.

Circular 165 emphasises that all relevant facts and circumstances should be taken into account to determine whether a Hong Kong holding company qualifies for DTA relief. The existence of any single 'adverse factor' should not, in itself, disqualify the DTA benefits claimant from being regarded as the beneficial owner of dividends.

It is encouraging that the SAT suggests that local tax authorities should not focus narrowly on certain individual factors under Circular 601 and apply them mechanically when determining the beneficial ownership of dividends. It proposes that they should rather perform and assess using a 'substance over form' approach. However, it remains unclear how the local tax authorities in each province will apply the new guidance in respect of single investment holding SPVs commonly used by real estate funds to hold China investments.

New Zealand

Proposed changes to further tighten interest deductibility

In January 2013, the Policy Advice Division of Inland Revenue and the New Zealand Treasury released an official issues paper reviewing the thin capitalisation rules. The issues paper seeks to further restrict eligibility for claiming New Zealand interest deductions when a business is owned by non-residents.

The main proposed change concerns the ownership structure of businesses. Currently, the thin capitalisation rules only apply when a business is controlled by a single non-resident. The issues paper proposes expanding this definition so that a group of non-residents holding an interest of at least 50 percent in the business and 'acting together' will be deemed to be a single non-resident controller. 'Acting together' will not be defined exhaustively in the legislation; however, it will include explicit cooperation or regulation of actions through a shareholder agreement, and coordination by a person or group of people.

It is uncertain how broadly Inland Revenue will interpret the phrase 'acting together'. It is intended to capture non-resident private equity investment, but will also capture non-resident investors in long-term infrastructure projects such as governmental public-private partnerships.

Other key proposals limit the debt or assets, which can be taken into account in the debt/asset calculation. The issues paper proposes that shareholder debt would be excluded from the debt amount which is used to calculate the worldwide group's debt to asset ratio. It also proposes that the following assets would be excluded from the asset base:

- Capitalised interest for which a tax deduction is claimed
- Asset revaluations from related party transactions (i.e. internal restructuring).

No changes are proposed to the safe harbour ratios of 60 percent for inbound investment and 75 percent for outbound investment. However, the issues paper signals that the treatment of debt held by finance and insurance companies may be reviewed at a later date, as well as the rules which reclassify certain debt as equity.

Vietnam

New protocol to Vietnam–Singapore tax treaty

A Second Protocol to the Vietnam-Singapore Tax Treaty was signed on 12 September 2012 and will take effect in Vietnam on 1 January 2014. The protocol notably reallocates taxing rights for capital gains on shares in companies possessing substantial real estate to the state in which the real estate is situated.

The article on capital gains of the treaty prior to this protocol generally gave the seller's state of residence the right to tax capital gains arising from the sale of shares in companies situated in the other state. Under the new protocol, gains derived from the disposal of shares in an unlisted Vietnamese SPV by a Singaporean holding company will be taxed in Vietnam, provided that more than 50 percent of the SPV's value is derived directly or indirectly from immovable property situated in Vietnam. Given that a full exemption on capital gains may currently be available in Singapore, this is a potentially significant amendment and a wider range of holding company options for Vietnam investment can be considered.

Malaysia

Real Property Gains Tax and stamp duty relief for listed business trusts

Following the establishment of the Business Trusts framework under the Capital Markets and Services Act 2007 (please refer to the Asia Pacific Real Estate Funds Briefing October 2012 issue), exemption orders have been gazetted such that business trusts will enjoy various tax benefits relating to their initial offering.

Under the exemption orders, Real Property Gains Tax relief will be available on the disposal of interest in real property to a trustee-manager acquiring on behalf of a business trust. Furthermore, the trustee-manager is not liable to stamp duty on instruments executed on behalf of a business trust in relation to the transfer of any business, assets or real property to the business trust. The exemptions will apply from 1 January 2013 to 31 December 2017.

While many real estate funds are unlikely to take advantage of these exemptions as few, if any, are looking to be publicly traded, the tax incentives offer institutional investors an alternative exit route in respect of their real estate investments in Malaysia.

Contact us

Christopher Abbiss
Asia Pacific Head of Real Estate Fund Tax
KPMG China
T: +852 2826 7226
E: chris.abbiss@kpmg.com

Scott Farrell
Partner, Tax
KPMG Australia
T: +61 2 9335 7366
E: spfarrell@kpmg.com.au

John Gu
Partner, Tax
KPMG China
T: +86 10 8508 7095
E: john.gu@kpmg.com

Tushar Sachade
Partner
KPMG India
T: +91 22 3090 2683
E: tushars@kpmg.com

David Lewis
Partner, Tax
KPMG Japan
T: +81 3 6229 8210
E: david.b.lewis@jp.kpmg.com

Cheol Kim
Partner
KPMG Korea
T:+82 2 2112 0930
E:ckim2@kr.kpmg.com

Nicholas Crist
Partner
KPMG Malaysia
T: +60 3 7721 3388
E: nicholascrist@kpmg.com.my

Paul Dunne
Partner, Tax
KPMG New Zealand
T: +64 9 367 5800
E: pfdunne@kpmg.co.nz

Alan Lau
Partner, Tax
KPMG Singapore
T: +65 6213 2027
E: alanlau@kpmg.com.sg

Van Hien Ninh
Partner
KPMG Vietnam
T: +84 838 219 266
E: ninhvanhien@kpmg.com.vn

Ivor Morris
Senior Manager
KPMG China
T: +852 2847 5092
E: ivor.morris@kpmg.com

kpmg.com/cn

Publication number: HK-PI13-0001

Publication date: July 2013