



## Introduction

The Asia Pacific region has long been regarded as an attractive destination for investment and has given rise to competition among local tax regulators in the areas of tax rates and tax concessions. These historical regimes do not always directly address the needs of Private Equity, who take their return through capital gains on individual investments.

The emergence of Private Equity as an investment force and agent of economic change in the region brings in to focus the policies of local tax regulators to the taxation of capital gains for non-resident Private Equity funds. The response of tax regulators to this issue can have a significant impact on the allocation of capital by Global Private Equity Funds.

This newsletter looks at recent developments in Asia Pacific countries regarding the taxation of capital gains by Private Equity funds, and discusses trends in the policies of local regulators on this important issue.

### Overview by jurisdiction

- Australia
- China
- Hong Kong SAR
- India
- Japan
- Republic of Korea
- Malaysia
- New Zealand
- Philippines
- Singapore
- Vietnam

## Australia

Australia has long been categorised as having an intransigent attitude to the taxation of capital gains by non-residents, and has pursued a campaign of negotiating changes to Australia's Double Tax Agreements (DTAs) to explicitly preserve Australia's rights to extract tax from these gains. Non-resident investors have traditionally resorted to mitigating their Australian exit risk by structuring their Australian investments through jurisdictions such as the Netherlands and Belgium which have resisted Australia's push to reform their DTAs.

Hence it came as a major surprise when the Treasurer announced a policy in the 2005/06 Budget to introduce new legislation exempting non-residents from capital gains tax on the divestment of shares in Australian companies, whilst retaining a right to apply tax where the relevant company was predominantly investing in Australian real estate.

Pursuant to this policy, amending legislation (which is still pending) will apply to exempt future gains made by non-residents on divestments of shares in Australian companies (except where the companies are "land rich").

Under Australian tax law, exit gains by Private Equity are likely to be regarded as Australian-sourced revenue gains, which means that Australian investments are still likely to be made only out of Treaty countries, but now with greater certainty that future exit gains will not be taxed.

The welcome and dramatic change of heart from Australian policymakers demonstrates the critical importance of attracting foreign investment in a competitive environment in which Private Equity is increasingly paramount. The same attitude, unfortunately, does not appear to extend to the Australian Taxation Office, which has signalled that it is investigating upstream structures. Ultimately, Australia stands to be disadvantaged if the policy and enforcement arms of government are not fully aligned.

## China

Private Equity investments in China have been benefiting from the favourable tax treatment provided under Chinese law to Foreign Invested Enterprises (FIEs). Such favourable tax treatment includes, among others, tax holidays for production oriented enterprises and dividend withholding tax exemption from such FIEs. FIEs refer to companies where the direct foreign equity interest is at least 25 percent of the total equity interest of the enterprises concerned.

In an effort to counter the widespread abuse of the favourable tax treatment by Chinese nationals and Chinese corporations who have been trying to convert their domestic investments into FIEs (so as to benefit from the favourable tax treatment available to FIEs), several ministries of the PRC government recently promulgated new Regulations on the Mergers and Acquisition of Domestic Enterprises by Foreign Investors. The new M&A regulations propose to end the FIE treatment of those domestic enterprises being acquired by foreign companies controlled by PRC nationals or PRC corporations. This will apply unless the relevant PRC enterprise satisfies the condition that real foreign investors contribute at least 25 percent of the total registered capital of the PRC enterprise concerned.

This change means that investments by PRC nationals and corporations would no longer be treated as FIEs and entitled to FIE tax benefits. This is likely to negatively affect Private Equity funds investing in PRC domestic enterprises which are to be converted to FIEs for listing on an overseas exchange. Typically, Private Equity funds have been quite active in investing in the above PRC targets through convertible bonds (rather than equities) prior to their IPO overseas. The change in law is likely to affect the valuation of the PRC targets and create withholding tax consequences on dividend payments as such investments made by Private Equity funds will no longer be eligible for FIE tax benefits, including a reduction in income tax rate and the dividend withholding tax exemption.

## Hong Kong SAR

Hong Kong has long been used as a place in which Private Equity groups have looked to establish a presence for investing in Asia, largely due to its proximity to most countries in Asia, its relatively low tax rates and straight forward tax regime. Hong Kong has a territorial based taxation system under which only Hong Kong sourced profits are subject to tax. The system also provides an exemption from tax for capital gains, dividends as well as certain other items of income.

Private Equity groups operating in Hong Kong have traditionally sought to structure their operations in a manner that mitigates the funds' exposure to tax in Hong Kong. That is, Private Equity funds generally maintain a position that the funds they manage are not subject to tax in Hong Kong. However, in the absence of a specific statutory exemption, there have been concerns within the industry that genuine offshore funds could have a technical exposure to Hong Kong tax.

With a view to maintaining Hong Kong's position as the preferred jurisdiction for Private Equity funds to establish their Asian operations, changes made this year seek to exempt a broader range of offshore funds from Hong Kong profits tax. Under the new legislation, non-resident funds will be specifically exempt from Hong Kong profits tax where certain conditions are satisfied, however many Private Equity funds will not be able to avail themselves of the exemption as investments made in private companies do not qualify for the exemption. The rationale for the exclusion of private companies is to prevent immovable property being simply transferred into a private company and then falling outside the Hong Kong tax net. Whilst this is understandable, the effect is that genuine investments made by Private Equity funds in private companies could still be exposed to Hong Kong profits tax. Any changes to the new provisions which allow for the exemption from tax for such investments would be well received.



## India

Against the backdrop of high and consistent GDP growth, India is presently considered one of the most attractive investment destinations in the region. Responding to the challenges and the needs of a fast growing economy, the government of India has introduced a series of tax and regulatory reforms to attract investors and thereby drive the economy forward. While the foreign investment regime has been continuously liberalised by the opening up of new sectors and simplification of procedures, the tax reforms have been directed towards a moderate tax regime coupled with greater focus on tax collections through stricter enforcement and rationalisation of tax structures.

With a view to bolstering the capital markets, the Indian tax laws provide for several concessions. At present, gains arising from the sale of shares through the recognised stock exchanges in India are not subject to capital gains tax, subject to a 12 month holding period rule. Furthermore, gains arising from the sale of shares held for a period of less than a year are taxed at a concessional rate of 11.22 percent. Dividends declared by Indian companies are not taxed in the hands of the shareholders although the company declaring dividends is subject to a dividend withholding tax of 14.025 percent.

Much of the foreign direct investment into India made during the last 15 years has been routed through Mauritius to take advantage of a more favourable India-Mauritius tax treaty, though the ongoing attractiveness of Mauritius continues to be debated.

The Indian tax and regulatory framework also encourages venture capital investments through a combination of tax concessions and an enabling regulatory framework specific to Venture Capital investments.

In totality, the emerging opportunities have prompted a sharp rise in Private Equity investments. This is just the beginning for India, an economy which is scripted by many to be one of the top three economic powers towards the middle of this century.



## Japan

In Japan, much of the reform in the past year has created further obstacles for investors. In a takeover bid, typically, it is not possible to acquire 100 percent shares in the target, such that share for share exchanges have had to be supplemented with paying out cash to the minority shareholders. Under the tax reform, if the share for share exchange involves any cash payment from the acquiring company to the shareholders of the target, the assets of the target will be revalued for Japanese tax purposes to market value and any unrealised gains/losses resulting from the revaluation will be treated as taxable gains/losses. Therefore, squeezing out the minority shareholders can now come with significant tax cost.

A further adverse change includes certain restrictions on the utilisation of tax losses including where companies with tax losses are used as special purpose acquisition vehicles.

Changes of this nature clearly do not directly promote increased investment into Japan.

## Republic of Korea

Generally, foreign investments in Korea using Private Equity have been made through a holding company located in a country where capital gains are exempt from Korean tax under the applicable tax treaty (for example in Labuan, Malaysia). However, the Korean government has recently enacted a new law stipulating application of the substance over form doctrine in the Korean tax law to prevent cases of treaty shopping which involve foreign investors making investments in Korea through a paper company in an overseas jurisdiction to utilise beneficial tax treaty treatment for tax avoidance purposes.

This new tax rule (article 98 -5 of the Corporate Income Tax Law) became effective on 1 July 2006 stipulating that foreign residents located in tax havens designated by the Ministry of Finance and Economy (MOFE) receiving dividends, interest, capital gains and royalties derived from the Korean investment first have to apply the Korean domestic withholding tax rate (27.5 percent) to such income (rather than apply the reduced rates under Korean tax treaties with the overseas country/ tax haven).

Korea has clearly been the controversial mover in the region, and Private Equity is likely to view potential Korean opportunities with concern.

## Malaysia

The territorial nature of Malaysia's tax system bodes well for Private Equity.

Non-Malaysian residents undertaking long-term direct investments in Malaysia will find that they are able to extract dividends and capital gains on the divestment of their Malaysian investments without suffering Malaysian taxes, with the exception of capital gains where these fall within the purview of Real Property Gains Tax.

The 'territoriality' concept does come with some limitation, and there is a possibility that the gains arising from the divestment of the Malaysian investment are revenue gains which are taxable in Malaysia. Not surprisingly, much of the investment into Malaysia is sourced from countries within Malaysia's tax treaty network, which may shelf revenue gains.

With the absence of a general capital gains tax regime as well as the non-imposition of dividend withholding tax and a treaty network covering more than 60 countries, Malaysia continues to be well-positioned as a country of choice for non-resident Private Equity investors.

## New Zealand

The tax environment in New Zealand has for some time reflected government policy to provide a level playing field to business and investors generally, and not to provide tax breaks or concessions to particular industries or classes of investors. Previous New Zealand governments have not felt the need to compete vigorously with overseas countries on tax policy.

In recent years, there has been some acceptance at a policy level that New Zealand needs to make itself more attractive as an investment destination for venture capital, and that tax plays a key role in this. As a result, we are starting to see changes in the New Zealand tax system that seeks to attract venture capital investment, or at least remove barriers to that investment.

The foreign investor tax credit regime was introduced to eliminate the cost of non-resident withholding tax on dividend repatriations. This went part way to reducing the cost of investing in New Zealand.

A traditional advantage in New Zealand has been the absence of a comprehensive capital gains tax regime; however, some gains are taxed as income. Under these concepts, a non-resident investor would be taxed in New Zealand on capital gains from the disposal of shares in a New Zealand company if the investor acquired the shares with the dominant purpose of resale, or if the profits form part of the investor's share income. New Zealand's double taxation agreements do not generally protect the non-resident investor from tax in this situation. This has proved problematic for overseas Private Equity investors and venture capital funds.

Recognising the need to make New Zealand a more attractive investment destination, recent tax changes exempt the non-resident from New Zealand income tax on these share gains in some sectors, but further relief would be welcomed in the financial services, mining, construction and infrastructure sectors.

## Philippines

In the Philippines, gains from the sale or disposal of capital assets are subject to capital gains tax, regardless of whether the seller is domestic or foreign. Gains from sale of capital assets are considered Philippine sourced income, and therefore are taxable in the Philippines regardless of the place of sale.

Private Equity funds continue to look to tax treaties for exemption from Philippine Capital Gains Tax (CGT) on the disposal of Philippine shares. Gains from the divestment of shares in Philippine companies owned by a resident of a treaty country are exempt from CGT, provided the assets of the Philippine company whose shares are being divested do not consist principally (more than 50 percent) of real property located in the Philippines. At present, the Philippines has concluded tax treaties with 38 countries. The local tax office has extended the CGT exemption to the sale of shares of stock listed and traded through the local stock exchange.

## Singapore

Singapore has had longstanding policies to attract Private Equity. One notable scheme is the Foreign Investors Scheme where profits from the sale of designated investments including shares in Singapore companies derived by foreign investors from funds managed by any fund manager in Singapore, is exempt from Singapore tax.

Demonstrating its preparedness to attract Private Equity, the government moved this year to extend the foreign investor tax exemption to Singaporean companies, provided the company is substantially owned by a foreign investor. Proposals of this nature can only serve to keep Singapore at the forefront when it comes to fostering Private Equity.

## Vietnam

Emerging markets in Asia are becoming increasingly attractive for Private Equity houses pursuing alternative investment strategies. Vietnam's efforts to liberalise its investment laws in light of its pending entry into the World Trade Organization (WTO) have created a new wave of interest in the country, as previously restricted assets and business sectors are suddenly open to foreign investors. Investing in a rapidly reforming legal and tax environment has its challenges, but a wave of new investment funds (such as the newly AIM listed Vietnam Holding, and the Dragon Capital-managed Vietnam Growth Fund) are seeking out direct equity investments in Vietnam's capital markets, the dynamic private sector, or newly emerging privatised state enterprises.

The tax regime in Vietnam historically focused on greenfield direct investment, with a fairly blunt capital gains tax imposed on foreign investors when exiting those investments. Planning for this focused on the use of special purpose offshore holding companies, helping to ensure any exit from the Vietnam asset occurred offshore, or the judicious use of Vietnam's quite thorough (but sometimes practically difficult to exploit) DTA network. Convergence of the previously distinct foreign and domestic corporate law regimes, and the emergence of alternative exit options (not the least of which is the increasingly attractive local securities exchange in Ho Chi Minh City), has left the tax regime struggling to keep pace, and international investors seeking more robust and sophisticated investment structures. We expect the tax regime to catch up with the recent investment and capital markets reforms in an effort to ensure the Vietnam treasury obtains its share of the growing national wealth.

# Conclusion

The Private Equity phenomenon poses many challenges for local policymakers, not least in the area of tax. The potential for Private Equity to extract significant gains tax free will inevitably raise local concerns, if not provoke strong reaction, as in Korea.

Fortunately, the temptation in some Treasuries to take a piece of Private Equity profits is countered by continuing tax liberalisation elsewhere. Tax is critical to the ability of Private Equity to cross borders. On the evidence, Private Equity appears set to remain a welcome contributor to the development of the region.





KPMG's Private Equity Group consists of experienced Private Equity professionals from around the Asia Pacific region who focus on the needs of the Private Equity community and its investors. It was established to support the link between a Private Equity fund, its managers, the transactions, the investments and the realisation of value.

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