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Private equity thought leadership
Quarterly top 10 tax topics

September 2022

Hong Kong tax development

1 Hong Kong proposes to refine its foreign source income exemption regime for certain passive income

In response to the concern of the European Union (EU) over potential double non-taxation arising from Hong Kong's foreign source income exemption (FSIE) regime for certain passive income, Hong Kong has recently released a consultation paper on the proposed refinement to the FSIE regime. This refinement is intended to enable Hong Kong to be removed from the EU watchlist of non-cooperative jurisdictions for tax purposes.

The related legislative bill is planned to be introduced in the last quarter of 2022 so as to bring the refined FSIE regime into force from 1 January 2023 with no grandfathering arrangement.

While Hong Kong will continue to adhere to the territorial source principle of taxation, it is proposed that Hong Kong constituent entities of a multinational enterprise group (MNE Group), wherever headquartered and irrespective of group asset size and revenue, will be subject to a refined FSIE regime in respect of in-scope offshore passive income received in Hong Kong.

The refined FSIE regime will apply to four types of passive income, namely: (i) interest; (ii) income from intellectual properties; (iii) dividends; and (iv) disposal gains in relation to shares or equity interest. Active income (e.g., trading profits and service income) will continue to be exempt from profits tax if it is regarded as offshore sourced based on Hong Kong's existing source rules.

The in-scope offshore passive income would continue to be exempt from profits tax in Hong Kong under the FSIE regime if (i) the income has not been received in Hong Kong or (ii) the entity concerned satisfies the economic substance or nexus approach requirements. Pure equity holding companies will be subject to a reduced economic substance requirement.

To avoid possible double taxation and relieve compliance burdens, it is proposed that the refined FSIE regime will introduce a participation exemption in respect of offshore dividends and disposal gains in relation to shares or equity interest. Regardless of whether the economic substance requirement is met, the relevant income will continue to be tax-exempt in Hong Kong if (i) the entity is a Hong Kong resident or a non-Hong Kong resident that has a permanent establishment in Hong Kong, (ii) the entity owns at least 5% of the shares or equity interest in the foreign entity, and (iii) no more than 50% of the income derived by the foreign entity is passive income.

The participation exemption rule is subject to the switch back rule under one of the specific anti-avoidance rules. If the income concerned or profits of the investee company (in case of dividends) is or are subject to tax in a foreign jurisdiction at a headline tax rate of below 15%, the tax relief will switch from the participation exemption to a foreign tax credit.

Recognizing that covered taxpayers would suffer double taxation if they do not qualify for exemption under the refined FSIE regime, a unilateral tax credit will also be introduced such that overseas taxes paid in respect of in-scope offshore passive income received from jurisdictions that have not concluded comprehensive double taxation agreements with Hong Kong will be creditable against the Hong Kong tax payable on the same income under the refined FSIE regime.

Relevant to private investment funds, based on discussions with the Hong Kong tax authorities, private investment funds and their Hong Kong holding platform / vehicles are not expected to be within the scope of the revised FSIE regime since consolidated financial statements are typically not required to be prepared and accordingly, not within the definition of a "MNE Group". It is also worthwhile to note that the revised FSIE regime will not override the existing preferential tax regimes in Hong Kong such as the Unified Fund Exemption regime.

For more details, please refer to our EY Hong Kong Tax Alert (2022 Issue No.6) dated 28 June 2022.

2 Limited liability partnerships without "issued share capital" are nonetheless entitled to intra-group stamp duty relief

The District Court (the Court) recently overturned a determination made by the Collector of Stamp Revenue (the Collector) who, while accepting that limited liability partnerships (LLPs) were bodies corporate, refused to grant intra-group stamp duty relief under section 45 of the Stamp Duty Ordinance (SDO).

The refusal was made on the grounds that the LLPs concerned, not having "issued share capital", could not therefore be 90% associated with the transferee within the terms of section 45 of the SDO.

Adopting a purposive interpretation approach, the Court rejected the narrow interpretation adopted by the Collector and held that the term "issued share capital" should be accorded its ordinary and natural meaning.

The Court held that so long as (i) the participating or share capital of an LLP was "issued", i.e., "having been legally given to (those entitled to the share capital) in a legally completed transaction"; and (ii) the share capital can be divided into quantifiable portions under the laws under which the LLP was incorporated, such capital qualified as "issued share capital" for the purposes of section 45 of the SDO. For more details, please refer to our EY Hong Kong Tax Alert (2022 Issue No.8) dated 28 July 2022.

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Australia tax development

3 Labor's multinationals tax integrity package

The current Labor government, as part of its election commitment platform, announced a multinational tax integrity package to address the tax avoidance practices of multinational enterprises (MNEs) and improve transparency through better public reporting of MNEs' tax information. Treasury released on Friday of a discussion paper on Multinational Tax Integrity and Tax Transparency on the Labor government's election proposals.

This discussion paper confirms that the many technical questions raised following the election announcements are open for discussion. It does not contain references to potential application dates (expected from 1 July 2023 or the 2023/24 year).

The discussion paper seeks to consult on the implementation of proposals to:

- Amend Australia's existing thin capitalization rules to limit interest deductions for MNEs in line with the OECD's recommended approach under Action 4 of the Base Erosion and Profit Shifting (BEPS) Program;
- Introduce a new rule limiting MNEs' ability to claim tax deductions for payments relating to intangibles and royalties that lead to insufficient tax paid; and
- Ensure enhanced tax transparency by MNEs, through measures such as:
    - Public reporting of certain tax information on a country-by-country basis;
    - Mandatory reporting of material tax risks to shareholders; and
    - Requiring tenderers for Australian government contracts to disclose their country of tax domicile.

The discussion paper does not consult on the following aspects of Labor's MNE Tax Plan:

- Implementation of the OECD two-pillar solution (which includes the 15% global minimum effective tax rate on profits of large MNEs). The consultation paper on Pillar Two is expected to issue in the coming weeks; and
- Implementation of a public registry of beneficial ownership to improve transparency on corporate structures, to show who ultimately owns or controls a company or legal vehicle.

The paper discusses the background to the proposals, policy issues and implementation considerations, with a series of consultation questions for each measure.

Responses to this consultation must be submitted by 2 September 2022. Following consideration of responses to the discussion paper, the Australian government will issue and consult further on exposure draft legislation prior to introducing any legislation into Parliament.

4 Proposed changes to Australia's thin capitalization rules (safe harbor debt test)

Entities subject to the current thin capitalization rules are required to calculate their adjusted average debt and compare it to the maximum allowable debt prescribed under Australia's thin capitalization rules. Currently, the maximum allowable debt is the greatest of:

- The safe harbor debt amount, which is set at 60% of the average value of the entity's Australian assets;
- the arm's-length debt amount, which reflects the amount of debt that could have been borrowed by an independent party carrying on the same operations as the Australian entity; or
- the worldwide gearing debt amount, which allows an entity's Australian operations to be geared up to 100% of the gearing of the worldwide group to which the Australian entity belongs.

The majority of Australian entities subject to the thin capitalization rules apply the safe harbor test.

As referred to above, the government has committed to adapting Australia's interest limitation rules to align with the OECD recommended approach, i.e., an earnings-based "safe harbor" test. The OECD outlined a framework in 2015 for a best-practice interest limitation rule, to discourage debt arrangements which are designed to minimize tax. This rule is known as the fixed ratio (earnings based) rule. The OECD's recommended approach limits net interest deductions to 30% of Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) and is intended to be a straightforward rule to apply.

5 Taxpayer Alert TA 2022/2 – Treaty shopping arrangements to obtain reduced withholding tax rates

On 20 July 2022, the Australian Taxation Office (ATO) issued Taxpayer Alert TA 2022/2 (TA 2022/2): Treaty shopping arrangements to obtain reduced withholding tax rates. The TA provides examples of treaty shopping arrangements that the ATO views as higher-risk arrangements which will warrant increased scrutiny by the ATO. The ATO uses TAs as an early warning to the community about a new or emerging activity or arrangement that is causing the ATO concern. The TA is intended to enable informed decisions by taxpayers, prevent further spread of higher risk arrangements and to demonstrate risk detection ability. Where the ATO is considering the application of specific or general anti-avoidance provisions, this can trigger the release of a TA.

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5 Taxpayer Alert TA 2022/2 – Treaty shopping arrangements to obtain reduced withholding tax rates (cont.)

The TA is directed at arrangements that seek to obtain a treaty benefit through interposition of one or more related entities between an Australian resident entity and the ultimate recipient of the royalty or dividend payment. Typically, the interposed entity is a resident of a treaty partner jurisdiction and the ultimate recipient is located in a jurisdiction that either does not have a double tax agreement (DTA) with Australia or if it is an existing treaty partner of Australia, the treaty benefit obtained under the DTA is less favorable for tax purposes.

The ATO recommends that in light of TA 2022/2, taxpayers should review their arrangements to identify transactions which may produce similar treaty benefits (i.e., reduced WHT) under Australia's DTAs with other treaty countries, whether as a result of a restructure or acquisition. The TA notes that taxpayers will often purport to have commercial justification for undertaking particular transactions in a particular way (e.g., commercial benefits and/or synergies flowing to Australian operations or an interposed entity). However, it is paramount that taxpayers maintain contemporaneous documentation and other objective evidence to substantiate their reasons for structuring a transaction in a particular manner. This will assist taxpayers to address the ATO's concern that reducing WHT rates was one of the principal or main reasons for a transaction and/or arrangement. In the absence of such documentation or objective evidence, the transaction/arrangement will more likely attract the operation of anti-avoidance rules in Australia's DTAs or domestic anti-avoidance legislation.

6 Australian Taxation Office extends transitional period for corporate residence determination

A foreign incorporated company is a resident of Australia if it carries on business in Australia and has its central management and control in Australia under section 6(1) of the Income Tax Assessment Act 1936. The ATO previously held the view in Taxation Ruling TR 2004/15 (withdrawn) (TR 2004/15) that this statutory test involved two separate requirements, i.e., the requirement to carry on business in Australia was separate to the requirement to have central management and control in Australia.

Following the High Court's 2016 decision in Bywater, TR 2004/15 was replaced by Taxation Ruling TR 2018/5 (TR 2018/5) with effect from 15 March 2017. The ATO's revised view in TR 2018/5 is that "the central management and control of a business is factually part of carrying on a business". If a company carries on business and has its central management and control in Australia, it will carry on business in Australia for the purposes of section 6(1). This interpretation of the corporate residency rules departed from the ATO's long held position on the definition of a corporate resident. The ATO also issued Practical Compliance Guideline PCG 2018/9 to set out its ongoing compliance approach toward corporate residency. The guidelines released included a transitional approach for certain foreign-incorporated companies.

The transitional approach was introduced for companies which, relied on the ATO's prior view on the central management and control test of residency as set out in TR 2004/15 and would not be residents, but which would now be considered residents under the ATO's revised views. The transitional approach was initially put in place until the earlier of 30 June 2022 (or 31 December 2021 for early balancers), however, the ATO on 29 June 2022 has now extended the transition period to 31 December 2022.

While the extension is welcomed, it should be considered in light of the proposed changes to legislature in relation to the corporate residency test. The Australian federal government, as part of the 2020/21 Federal Budget, included proposed changes to the corporate residency test. Under the proposed new measures, a foreign incorporated company will be treated as an Australian tax resident only if it has a "significant economic connection to Australia", a less stringent residency two prong test requiring not only central management and control to be in Australia for residency to apply but also the company's core commercial activities are undertaken in Australia. These measures are proposed to apply retrospectively from 15 March 2017 onwards. While specific legislation has not yet been released an exposure draft may be made public soon for consultation.

7 US global intangible low-taxed income (GILTI) rules do not correspond to Australia's controlled foreign company (CFC) rules for hybrid mismatch purposes

On 29 June 2022, the ATO issued Tax Determination TD 2022/9 (TD 2022/9) - finalizing the ATO's view on whether the US GILTI rules correspond with the Australia's CFC rules for the purposes of the Hybrid Mismatch rules found in Division 832 of the Income Tax Assessment Act 1997. TD 2022/9 confirms the ATO's original view contained in the prior draft Taxation Determination TD 2019/D12 being that the US GILTI rules do not correspond to the Australian CFC rules for the purposes of determining whether an amount is "subject to foreign income tax" under the hybrid mismatch rules.

The impact of this view being that taxpayers cannot rely on payments being subject to the US GILTI rules to support that those amounts have been included in the calculation of a foreign tax base to mitigate or eliminate the application of the Australian hybrid mismatch rules.

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India tax development

8 New fund management regulations notified for fund management entity (FME) set-up in Gujarat International Financial Technology (GIFT) City, India's offshore center

The unified regulator in GIFT city, i.e., International Financial Services Centres Authority (IFSCA) has issued final Fund Management Regulations (Regulations) superseding existing framework for set up of funds in GIFT.

The Regulations have been issued in furtherance of IFSCA's objective to develop a best-in-class regulatory regime for funds and fund managers within the International Financial Services Centre (IFSC) that will support the growing aspirations of the asset management industry and development of IFSC as a leading global destination for the industry.

Some of the key features of the Regulations:

- A unified registration for multiple fund activities where fund manager would be regulated instead of the existing approach of regulating the Funds;
- A green channel route to launch Venture Capital Schemes or non-retail schemes soliciting money from accredited investors;
- Substance requirements for the FME have been defined;
- Recognition of family investment fund;
- Liberal co-investment regime through a special purpose vehicle or through a segregated portfolio by issuing a separate class of units;
- Introduction of Special Situation Funds to invest in special situation asset to incentivize funds with a distressed strategy
- Innovation to fund activities by giving power to the IFSCA to provide relaxations from the applicability of all or any of the requirements of the Regulations;
- Permission to funds to invest up to 20% of corpus in physical assets such as real estate, bullion, art or any other physical asset;
- Focus on Environmental, Social and Governance (ESG): Funds with focus on ESG sectors/strategies permitted to be launched. Relatedly, the Regulations also specify disclosure and reporting on matter relating to sustainability; and
- Launching of retail schemes such as mutual funds opening avenues for cross-border investments. They can also launch Exchange Traded Funds (ETFs), which can be either equity, debt, commodity, hybrid, actively managed, etc. Gold and Silver ETF fund managers can invest in Bullion Depository Receipts.

The Regulations provide ease of doing business and a globally competitive financial platform for the comprehensive range of international financial services to international issuers which would then tap global capital flows to meet India's development needs.

The overall risk-based approach and regulating the manager instead of the Funds provide significant operational flexibility for Fund managers to launch a number of funds / schemes without incurring significant cost or time. This could be one of the major drivers for setting up of Fund structures in GIFT city especially with narrow deal timelines.

The regulatory relaxations such as co-investment opportunities, permission to take leverage for Funds (non-retail) would simplify deal structuring, provide flexibility to Funds based in IFSC and investors to allocate more capital to lucrative opportunities and ensure the Funds based in IFSC are competitive with other offshore fund vehicles.

Regulations pertaining to Family Investment Funds make it easier for family offices to run their own investment fund with minimum restrictions. Innovation Sandbox and Fund lab allow fund managers to test new strategies in a controlled environment and develop new track record for their Fund. Recognition and regulation of purpose driven Funds such as ESG Funds would allow international investors to channelize and participate in ESG transitions in India and other markets.

9 India tax tribunal ruling questions tax officer's approach of reading the concept of "beneficial ownership" for the purpose of capital gains article absent express language

In a recent ruling on the availability of India-Mauritius tax treaty (IM Treaty) on the capital gains earned by a private equity Fund based in Mauritius from the sale of grandfathered Indian shares (i.e., shares acquired prior to 1 April 2017), the Mumbai tribunal raises a fundamental question on whether the concept of "beneficial ownership" can be read into the scheme of Article 13 of IM treaty absent express language similar to one used in Article 10, Article 11 of IM Treaty.

Reference has been made to foreign court rulings / commentaries which suggest that inclusion of beneficial ownership concept in Article 13 is not currently part of common tax treaty practice of any country.

The tax officer had denied the benefit of IM Treaty by lifting the corporate veil of the taxpayers and noting that the real/ beneficial owners of the taxpayers were in Cayman Islands. The Tribunal asked the tax officer to not make presumption assessment and re-decide the issue after taking into account the fundamental concept of "beneficial ownership" and its application in Article 13 after providing the taxpayers reasonable opportunity of being heard.

The ruling does challenge the legality of tax officer's approach of applying the principles of beneficial ownership while interpreting provisions of Article 13 and therefore potentially could aid in defending the claim of capital gains tax exemption made under relevant tax treaty.

Global tax development

10 Update on BEPS 2.0 – Pillar One and Two

Pillar One

The Secretariat of the OECD recently released multiple public consultation documents regarding Pillar One of the OECD/G20 project on Addressing the Tax Challenges Arising from the Digitalization of the Economy (the BEPS 2.0 project).

On 4 April 2022, the OECD Secretariat released a public consultation document with draft rules regarding scope under Amount A for Pillar One. The new taxing right established through Amount A only applies to those MNE Groups that fall within the defined scope of Amount A. The scope of Amount A is based on two threshold tests: (i) a global revenue test and (ii) a profitability test. Both of these tests are to be met for a Group to be considered a Covered Group under the Amount A rules. Based on the consultation document, the global revenue test requires a Group to have total revenues greater than EUR20 billion. The profitability test is a three-pronged test that is met if the Group's pre-tax profit margin is: (i) greater than 10% in the period (ii) in two or more of the four periods preceding the period and (iii) on average across the period and the four periods immediately preceding the period.

The agreement by the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) excludes extractives and regulated financial services. The OECD Secretariat also released a public consultation document regarding the Extractives Exclusion (14 April 2022) and regarding the Regulated Financial Services Exclusion (6 May 2022) under Amount A for Pillar One.

On 27 May 2022, the OECD Secretariat released two public consultation documents regarding the Tax Certainty Framework for Amount A and Tax Certainty for Issues Related to Amount A for Pillar One.

The Tax Certainty Framework set out in the first consultation document aims to guarantee certainty to MNE Groups in relation to all aspects of the Amount A rules. Any disagreements that arise during these tax certainty mechanisms are to be resolved by a binding determination panel process. In addition, if a Group does not invoke these certainty mechanisms, the Framework includes the potential for tax administrations to agree to work together through a coordinated review.

The second consultation document on Tax Certainty for Issues Related to Amount A contains draft provisions setting out a mandatory binding mechanism to resolve transfer pricing and permanent establishment profit attribution disputes that are unable to be resolved through the Mutual Agreement Procedure (MAP) within two years of the presentation of the MAP case to the competent authorities.

The consultation documents are working documents released by the OECD Secretariat to obtain input from stakeholders. They are released without prejudice to the final agreement and do not reflect consensus of the Inclusive Framework member jurisdictions on the substance of the documents.

Pillar Two

On 25 April 2022, the OECD held a public consultation meeting on the Implementation Framework for the Pillar Two Global Anti-Base Erosion (GloBE) Rules (the Implementation Framework). The four questions on which the OECD/G20 Inclusive Framework on BEPS (the Inclusive Framework) was seeking input were outlined in the invitation to provide comments, which was released on 14 March 2022.

During the public consultation, four panels discussed the input provided by commentators in response to the questions posed by the Inclusive Framework. The meeting focused on the mechanisms necessary to ensure that tax administrations and MNEs can implement and apply the GloBE Rules in a consistent and coordinated manner. Additionally, at the end of the session, the OECD Secretariat addressed some technical questions related to the GloBE Rules. The subject matter of this consultation did not extend to the policy choices reflected in the GloBE Rules or the Commentary but rather focused on how to facilitate the implementation and administration of the GloBE Rules.

The public consultation provided a valuable opportunity for businesses to share practical perspectives on compliance and simplification matters in the development of the GloBE Implementation Framework. The consultation meeting highlighted the complexity of the GloBE Rules and the importance of a detailed Implementation Framework including simplifications, processes for coordinated interpretations and mechanisms to provide tax certainty. According to the implementation plan released in October 2021, the GloBE Implementation Framework will be released by the end of 2022 at the latest, which provides a short timeframe for its development. The OECD Secretariat indicated during the consultation meeting that further refinements to the Implementation Framework will need to continue to be made after the implementation of the GloBE Rules by Inclusive Framework member jurisdictions.

It is important for businesses to evaluate the potential impact of the global tax changes both on their tax positions and on their data and compliance processes and systems. Businesses should also monitor activity in relevant jurisdictions related to the implementation of the global minimum tax rules into their domestic tax legislation.

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EY Asia-Pacific key Private Equity Tax contacts

Ian Scott
EY Asia-Pacific Private
Equity Tax Co-Leader
+61 2 9248 4774
Ian.Scott@au.ey.com

Adam Williams
EY Asia-Pacific Private
Equity Tax Co-Leader
+852 9400 4535
Adam-B.Williams@hk.ey.com

Darryl Kinneally
EY ASEAN Private
Equity Tax Leader
+65 6309 6800
Darryl.Kinneally@sg.ey.com

Matt Weerden
EY Oceania Private
Equity Tax Leader
+61 2 8295 6788
matt.weerden@au.ey.com

Masako Kanaya
EY Japan Private
Equity Tax Leader
+81 3 3506 2430
Masako.Kanaya@jp.ey.com

Subramaniam Krishnan
EY India Private
Equity Tax Leader
+91 226 192 1949
subramaniam.krishnan@in.ey.com

This quarter's contributors

Adam Williams
Maggie To
Matt Weerden
Niraj K Shah
Michelle Chua
Subramaniam Krishnan