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Tax Risk Management & Compliance in Asia

Contact

Claus Schuermann
Certified Tax Adviser (Germany)
Partner

Tel: +852 2528 1229
Email: claus.schuermann@wts.com.hk

WTS Hong Kong Ltd.
Unit 1004, 10/F, Kinwick Centre,
32 Hollywood Road, Central
Hong Kong
www.wts.com.hk

1 Introduction

Economically bad times create additional risk for incompliant behaviour. And times are not so good globally: Global GDP growth is expected to be only around 2% for 2012 and the Eurozone will likely show a negative growth rate. Even China may not achieve the 8% growth rate which is assumed by some to be the necessary growth to keep social stability.

Further to the lack of growth, the fiscal coffers of many developed countries are running low. So fiscs have basically three alternatives to increase tax revenue: increase the tax rates, which they do not dare to do, fearing to drive away investors; broaden the tax bases, which they do not want for the same reason; or give an extra effort to make incompliant taxpayers actually pay their fair share of taxes.

Global developments suggest that all western countries agree to pursue the third way. Besides, since 2009 the OECD is giving an extra effort to step up the exchange of information between states.

Read more in the following …

2 Compliance

In business terminology, “compliance” in the narrower sense describes the observation of rules and the adherence to standards, i.e. compliance with statutes, regulations and voluntary codes. It also increasingly relates to ethical conduct and integrity in more comprehensive terms. We define compliance as a managerial function of every entrepreneur and every company, inseparably linked to the principles of good governance and leadership.

Why is compliance indispensable today?

An effective compliance program and function will “release” companies from any accusation that they have infringed their supervisory obligations, and also guard against the risk of litigation and the exorbitant costs associated therewith. An effective compliance system will furthermore prevent companies unwittingly becoming involved in dubious activities through their association with business partners such as suppliers, joint venture partners or sales agents. An effective – and moreover efficient – compliance program will also open up business opportunities in markets or regions in which only “clean” business dealings will have any chance of success in the long term, due either to the application of extremely tight statutory requirements and state supervision, or to a marked tendency towards corruptive practices. Furthermore, compliance is increasingly becoming a factor that has a material influence on the value of companies in the capital markets – as is clearly demonstrated by the growing importance of a number of indices, such as the Dow Jones Sustainability Index, the FTSE4Good Index and the Domini 400 Social Index, which focus on compliance.

Increasing requirements worldwide

The ever increasing requirements of the past few years in respect of the compliance with law and regulations generally and the sustained prevention and combating of corruption in particular are the result of the drastic recent increase in criminal proceedings brought against globally active companies on the basis of the US Foreign Corrupt Practices Act (FCPA). Although the FCPA has actually been in force with far-reaching international effect since 1977, the initiation of criminal proceedings on the basis of the FCPA has reached an unprecedented level in the past couple of years. Thus, on the one hand, eight of the ten largest settlements to date – with a cumulated penalty amount in excess of 2 billion US dollars – were awarded in 2010 alone. On the other hand, eight of these ten settlements were reached with non-US companies. It may be expected that the number of criminal proceedings will continue to increase further, now that current statutory amendments such as the US Dodd Frank Act of 2008 – actually a statute intended to regulate the capital markets – holds out the prospect of large sums by way of incentive and reward to whistleblowers, in some cases as much as 30% of the compensation payments ordered by the courts. The coming into force of the UK Bribery Act 2010 as of 1 July 2011 constitutes a second significant and very recent development. The exterritorial scope of the binding effect and obligatory character of this UK legislation may be described as even greater than that of the US FCPA. Unlimited penalty payments may be imposed on companies, and prison sentences of up to ten years may be imposed on employees. Non-UK companies that maintain a representative office, have established a subsidiary or have business dealings with agents or distributors within the United Kingdom, will also fall within the scope of the UK Bribery Act. In Germany, the introduction of section 299 of the German Criminal Code (Strafgesetzbuch) in 1999 made both active and passive corruption in the context of business dealings not only in Germany but also abroad subject to fines and even imprisonment. This represents one of the most internationally far-reaching provisions of German criminal law.

High risk of corruption in key export markets

Germany is a globally leading export nation. According to information provided by the Ifo Institute in Munich, the People's Republic of China will constitute Germany's second most important export market after France in 2011, and German companies will export goods in the value of EUR 66 billion to China in 2011. (By way of comparison: Goods in the value of EUR 94 billion will be exported to France in 2011.) This is almost double the equivalent figure for 2009, which amounted to EUR 36.5 billion. China will therefore supplant Germany's traditional trading partners, such as the USA, Great Britain and the Netherlands, on its export balance sheet.

The People's Republic of China is, however, considered to be highly incompliant by the Corruption Perception Index (CPI) of Transparency International (TI), which is recalculated on an annual basis. According to the CPI, the People's Republic of China only attained index values of less than 4.0 in the past five years; in the past year, during which it recorded an index value of 3.5, a further downward trend could be discerned, an indication of the existence of widespread corrupt business practices. A consideration of further emerging market countries within the BRIC group paints a similarly problematic picture. While great opportunities for growth are being predicted against the background of the major upcoming sporting events in Brazil (the 2014 football World Cup and the 2016 Olympic Games), the risk of corruption is at the same time considered to be particularly high. In 2010, Brazil attained a CPI value of 3.7 and the 69th position in the TI Corruption Perception Index. China held the 78th position, India, with a CPI value of 3.3, the 87th position and Russia, with a CPI value of merely 2.2, only the 154th position. By way of comparison: In the current version of the Corruption Perception Index, Germany has a point value of 7.9 and holds the 15th position; Singapore attained 9.3 and thus in 2010 shared the top position among 178 assessed countries worldwide with New Zealand and Denmark. German companies must therefore arm themselves against a high level of corruption risk in key export markets. As a result of ever more tightly interlinked production and supply chains, products from German companies which are "made in China" but sold, for example, in the highly regulated US market may give rise to considerable contamination and liability risk.

On Hong Kong

Latest developments in Hong Kong include considerable changes to the Companies Ordinance. The new Companies Bill was passed by Hong Kong Legislative Council on 12 July 2012. One main purpose of the changes is to improve corporate governance.

Thus, according to the new Companies Ordinance it will be necessary for each privately held company to have at least one natural person as Director. Up to now, it is not uncommon to have only one corporate Director, particularly for conduit companies. Furthermore, clarifications are introduced with regard to directors' skills, diligence and duty of care. And the powers of auditors are being increased so that they can inquire for information from a larger group of persons involved in the business of the company audited. Person not adhering to the auditors request are committing a criminal offence.

3 Tax compliance and risk management

What do we understand by tax compliance and risk management? Tax compliance is the correct application of all tax regulations to the company's (or for that purpose individual) tax situation. Risk management with regard to taxes includes the approach a company takes in taking risks by accepting higher or lower tax risks in uncertain tax situations. It is part of the entrepreneurial risks and decision-making whether to take a more aggressive approach in tax structures or to apply a more conservative approach.

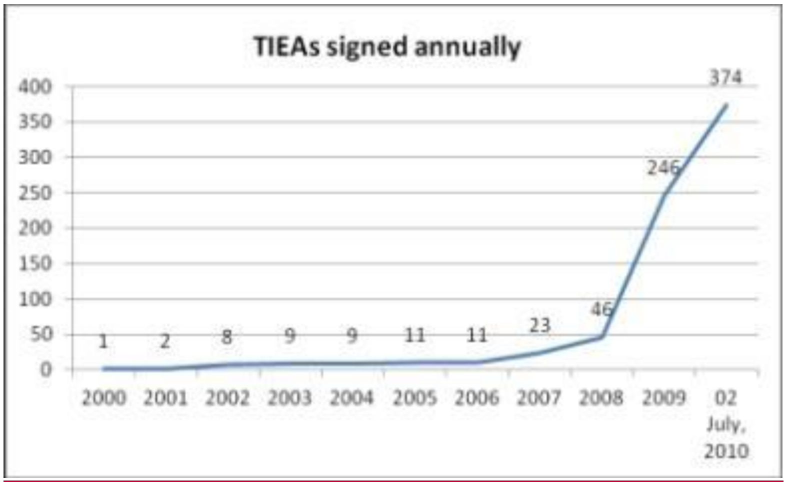
Now, what is the connection between Compliance in general and Taxes? The most common motivations for money laundering are illegal narcotics trading followed by tax evasion.[1] Since 2009 there is an increased focus on tax transparency and fighting of tax avoidance in a combined international effort that was initiated during the G20 summit in this year.

On a global level, **the OECD** (Organisation for Economic Cooperation and Development) in 2000 had setup the so-called "Global Forum"[2]. The Global Forum gained speed in 2009 when it was restructured and the number of member countries increased. Since then, 91 peer reviews have been launched (and 70 have been completed), 446 recommendation have been issued to jurisdictions to improve their ability to cooperate in tax matters and over 37 jurisdictions have introduced or proposed changes to their local laws to achieve compliance with OECD standard.

In the **European Union**, the previous Directive (Directive 77/799/EEC) on cooperation regarding information had been repealed and replaced by Directive 2011/16/EU on 15 February 2011. Under the new Directive, extensive exchange of information is foreseen, including passing information to a third country under certain conditions.[3] Generally, 3 types of cooperation are regulated, i.e. exchange of information on request[4], mandatory automatic exchange of information[5] and spontaneous exchange of information[6]. The authority of one member state may under the Directive provide information received from a third country to another member states authority. This may however be restricted under existing agreements (i.e. Tax Information Exchange Agreements (TIEA) or Agreements on the avoidance of double taxation (DTA)) with the treaty partner.

On this basis, **Germany** will start to automatically distribute information from 1 January 2015 with regard to tax years from 1 January 2014.

In the developed world and particularly in the larger economies with traditionally high tax rates there has been anti tax avoidance regulation for a long time. But with regard to cross-border transactions and setups it has always been difficult to collect the necessary data to correctly assess taxes. This gap is increasingly being closed with the drastic increase of Tax Information Exchange Agreements since 2009, as can be seen from the following chart.



Source: OECD

[1] Turner, Money Laundering prevention, p. 25 (Kindle version)
[2] The Global Forum on Transparency and Exchange of Information for Tax Purposes
[3] As stated in the introductory notes to the Directive under point (18)
[4] Chapter II Section I, Art. 5
[5] Chapter II Section II, Art. 8
[6] Chapter II Section III, Art. 9

At the same time, in emerging markets, such as **China** and **India**, anti-avoidance regulations are being established for the first time.

Since 2008, China emphasises anti-avoidance and has both introduced regulations and also aggressively applied these new rules. The latest is the tests of beneficial ownership when applying for tax treaty relief.

This is a particularly relevant development for the typical holding locations **Hong Kong** and **Singapore**. These initiatives will have an impact on tax structures implemented in or via low tax jurisdictions such as Hong Kong, Singapore and others. Up to now, Hong Kong and Singapore have been regarded as low tax jurisdictions with rather simplistic tax systems and because of this as location of choice for the interpositioning of holding companies for investments to various countries.

On India

India as a tax jurisdiction is witnessing radical changes on the taxation front, particularly in the area of direct taxes and particularly on the International Taxation Front. Recent land mark judgement of the Hon'ble Supreme Court in the case of *Vodafone International Holdings B.V.* v. *Union of India* has laid down certain far reaching principles on "form" and "substance". The reaction of the Government to this judgement has been very notable in terms of bringing various retrospective amendments.

General Anti Avoidance Rules (GAAR) have been inserted in the statutes and its applicability is deferred by one year. GAAR would be invoked when there is Impermissible Avoidance Arrangement (IAA). IAA means an arrangement the main purpose or one of the main purposes of which is to obtain a Tax benefit and which results in one of the main purposes of which is to obtain a Tax benefit and which results in one of the following situations:

- It creates rights and obligations which are not at Arm's Length.
- It results in misuse or abuse of provisions of this Act.
- Lacks/deems to lack commercial substance.
- Not ordinarily applied for *bona fide* purposes.

Once GAAR is invoked the consequences spelt out are only illustrative and not exhaustive. Once GAAR is invoked the provisions of tax treaty which are otherwise applicable would become inapplicable. In other words, tax treaty provisions will be overridden by the domestic law provisions if and when GAAR is invoked.

The expert committee headed by Mr Parthasarathi Shome on GAAR in India, as constituted by the Indian Prime Minister, has submitted its draft report. Inter-alia, the key recommendations of expert committee are:

- GAAR should be deferred by three years; therefore it would apply from assessment 2017-18;
- GAAR would be applicable only if a tax benefit of INR. 30,000,000 and above has been obtained by the taxpayer;
- Where Circular No. 789 of 2000 (Tax Residency Certificate) with respect to Mauritius is applicable, GAAR provisions shall not apply to examine the genuineness of the residency of an entity set up in Mauritius.

- GAAR should not be applicable if FII offers to be taxed under domestic laws;
- GAAR should not be applicable if non-resident invests in listed securities through FIIs;
- Abolition of tax on gains arising from transfer of listed securities (both capital gains and business income);
- All investments (though not arrangements) made by a resident or non-resident and existing as on the date of commencement of the GAAR provisions should be grand fathered so that on exit (sale of such investments) on or after this date, GAAR provisions are not invoked for examination or denial of tax benefit.;
- GAAR should not be allowed to over-ride the anti-avoidance provisions of treaties (i.e. limitation of benefit, etc.);
- Onus should be on revenue to prove if a transaction is impermissible avoidance agreement;
- Amendment to the Act to provide that only arrangements with sole purpose (and not one of the main purpose) of obtaining tax benefit should be covered under GAAR;
- Tax consequences of 'impermissible avoidance arrangements' should be limited to the tainted part of the transaction;
- Definition of 'connected person' under Sec. 99 should be restricted to 'associated person' and 'associated enterprise' only;
- AAR should decide the GAAR cases within 6 months;
- A 'negative list' for the purpose of invoking GAAR should be provided;
- 'Tenure of arrangements, payment of taxes and an option to exit' should be given due weightage while deciding if arrangements lack commercial substance;
- GAAR not to be invoked if taxpayer submits a satisfactory undertaking to pay tax along with interest in case GAAR provisions are made applicable in relation to the remittances;
- Extensive training of Assessing officer to be placed in the regime of International Taxation; and
- Various illustrations have been given where GAAR will be considered as applicable or not applicable

4 Conclusion

From now on, in order to manage tax risks sufficiently it will be necessary to take a much more integrated approach by assessing all countries and jurisdictions which have a stake in the business of the company, which typically includes those countries from which payments are received, as they often (at least in Asia) will apply withholding taxes. Reduction of withholding tax rates under tax treaties are often available, but increasingly require proof of beneficial ownership.

The global developments on transparency are arriving in locations such as Hong Kong as well. Based on the peer review by the Global Forum, Hong Kong is now considering to change the local tax laws so that pure information exchange agreements with other countries will be allowed, which up to now is generally not possible. This would enable foreign countries' tax authorities to enquire and collect tax relevant information directly from the Hong Kong Inland Revenue Department (IRD).

These combined developments of increasingly aggressive anti-avoidance regulations in both the western countries but also in the emerging markets require sophisticated tax risk management in order to avoid future surprises in the tax bill.

Author:

WTS Hong Kong Limited
Unit 1004, 10/F, Kinwick Centre,
32 Hollywood Road, Central
Hong Kong S.A.R.
Tel +852 2528 1229
Fax +852 2548 1209
info@wts.com.hk
www.wts.com.hk

