EY Asia-Pacific private equity tax network

Private equity thought leadership Quarterly Top 10 tax topics

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Building a better working world

Australia tax developments

1 Updated list of Exchange of Information Countries (with Australia)

The Australian Taxation Administration Amendment (Updating the List of Exchange of Information Countries) Regulations 2021 amends section 34 of the Taxation Administration Regulations 2017 to:

- Add Dominican Republic, Ecuador, El Salvador, **Hong Kong (SAR of China)**, Jamaica, Kuwait, Morocco, Republic of North Macedonia and Serbia to the list of foreign countries /regions, which are 'information exchange countries' for the purposes of subsection 12-385(4) of Schedule 1 to the Act; and
- Remove Kenya from the list of information exchange countries.

As Hong Kong is a major international financial center, it is pleasing that from 1 July 2021, Hong Kong resident investors will be eligible for the concessional 15% withholding tax on certain Management Investment Trust (MITs) distributions. This is extremely welcome for pan-Asia real estate funds that may want to set up their holding platform in Hong Kong.

2 Board of Taxation's second consultation paper on review of Capital Gains Tax Rollovers

The Board of Taxation (Board), the advisory panel to the Australian Government on tax law reform, published a second consultation paper for stakeholders' review and input. The paper sets out the Board's first-stage proposal for rationalizing (and replacing) seven of the key roll-overs that deal with the most common business restructuring transactions, including mergers (i.e. takeovers), demergers, and internal reorganizations.

The second stage of the Board's review to consider extending the general business restructure roll-over application to transactions not covered by existing reliefs is also important. This should include examining expanding the proposed general business restructure rollover to include superannuation funds or else providing specific relief to allow superannuation funds to restructure investment holdings particularly as between wholly-owned entities.

If the Government is minded to introduce a general business restructure roll-over, it is important that such a roll-over does not add any new limitations to currently available roll-overs but rather focuses on providing greater certainty and flexibility and reducing complexity of the CGT roll-over regime.

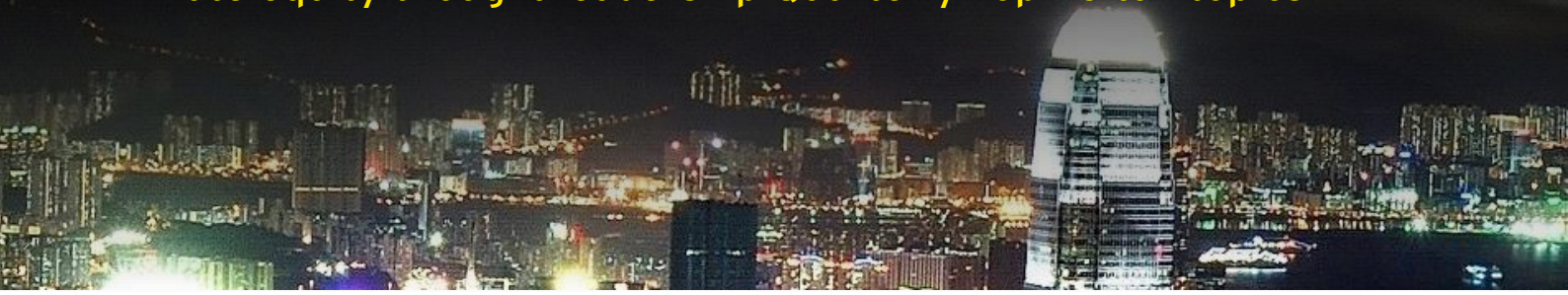
The availability of rollover for vending shareholders is often critical to enabling private equity sponsors to facilitate continuing investment by shareholders and management in the business post deal.

3 Final ruling LCR 2021/1 – OECD hybrid mismatch rules: targeted integrity rule in respect of cross border finance

The Australian Taxation Office has issued its final ruling in respect of the targeted integrity rule (Ruling) in Australia's hybrid mismatch rules. This Ruling provides the Commissioner's view of particular aspects of the law in relation to the hybrid mismatch targeted integrity rule, legislated as part of the package of measures making up Australia's hybrid mismatch rules.

The hybrid mismatch rules are intended to deter the use of certain hybrid arrangements that exploit differences in the tax treatment of an arrangement and/or entity under the income tax laws of two or more countries. When applicable, they neutralize the effect of hybrid mismatches so that unfair tax advantages do not accrue for multinational groups as compared with domestic groups. The hybrid mismatch rules, including the targeted integrity rule, apply to pre-existing arrangements in the same way as they apply to arrangements entered into after the application date of Division 832.

In addition, the hybrid mismatch rules include the targeted integrity rule, which seeks to prevent offshore multinationals from otherwise circumventing the hybrid mismatch rules by routing investment or financing into Australia via an entity located in a no- or low-tax (10% or less) jurisdiction. Were it not for the targeted integrity rule, the result of the interposition of such an entity, would be to effectively replicate a Deductible/Non-inclusion mismatch but fall outside the scope of the operative provisions of Division 832 pertaining to a Deductible/Non-inclusion. Under Subdivision 832-J, where the core elements are present, the targeted integrity rule will apply to deny the deduction for a payment of interest or an amount under a derivative financial arrangement.



4 Final guidance on outbound interest-free loans between related parties

The Australian Taxation Office has released the final version of Schedule 3 to its Practical Compliance Guideline PCG 2017/4 (PCG 2017/4C5) in relation to outbound interest-free loans (IFLs) between related parties.

There are also minor updates to the PCG's other Schedules, reflecting the latest version of the Australian Taxation Office's Reportable Tax Position (RTP) Schedule.

The Australian Taxation Office maintains the presumption that IFLs between related parties are high risk (amber risk zone), before consideration of any other characteristics of the financing arrangement.

They have made four notable and important changes in the final Schedule as follows:

- The final Schedule applies from 1 January 2020. However, it applies to both new and existing instruments.
- The sovereign risk factor that operated to increase the risk where the borrower was in a less risky jurisdiction, has been removed. As a result, the potential total "pricing" risk scoring is lower (a positive outcome) for a number of taxpayers.
- References to the reconstruction provisions in the transfer pricing legislation have been removed but the legal position will remain relevant for taxpayers even though it is not overtly included in the risk scoring exercise.
- The Schedule has been re-worded and confirms that the characterization of an interest-free outbound loan should not change over the life of the transaction without a material change to either the arrangement or the borrower's circumstances.

Unfortunately, the Commissioner has not included further guidance in relation to inbound IFLs. The analysis to satisfy the requirements in the final PCG are potentially complex and subjective. It will require taxpayers to devote significant time to gather "evidence" that supports their position.

Mainland China tax developments

5 Guidelines for the Application of Regulatory Rules – Disclosure of Shareholder Information by Companies Applying for Initial Public Offerings (IPO)

On 5 February 2021, China Securities Regulatory Commission (CSRC) released the "Guidelines for the Application of Regulatory Rules – Disclosure of Shareholder Information by Companies Applying for Initial Public Offerings" (Guidelines) to strengthen the supervision of disclosing the information of shareholders and ultimate beneficial owners (UBO) of the companies to be listed. The main contents of the guidelines are outlined as follows.

- Reiterate the principle requirements of the eligibility of the issuer's shareholders. The shareholders of the issuer are required to clean up any nominee shareholding arrangement in accordance with the law before submitting the IPO application. Meanwhile, the issuer should provide a special undertaking that its shareholders' qualification follows the relevant state regulations and there are no irregularities in shareholdings.
- Strengthen the supervision of share entry before IPO. The issuer should disclose details of any new shareholders who purchased shares within 12 months prior to submitting the IPO application and the new shareholders are required to lock up their shares for 36 months.
- Where any corporate or limited partnership shareholders of the issuer has multi-layer holding structure with no actual business activities and purchased the issuer's share with abnormal price, the intermediary should look through the structure to identify the UBO and declare whether there are any violations of the shareholder eligibility requirements and nominee shareholding arrangement. The issuer is also required to state the background information of the UBO if the UBO is a natural person.
- Where the issuer's shares are held by any financial products, the issuer is required to disclose the information on the regulatory coverage of the financial products.
- Sponsors, securities brokers and other intermediaries should verify in due care the information disclosed by the issuer.

What issuer and intermediaries should do?

- PE Funds should consider if they are required to disclose their limited partners as part of any upcoming IPO process.
- Revisit the shareholding structure to ensure the compliance of the Guidelines.
- Identify any needs of restructuring plan before IPO application.
- Assess the tax implications for rectifying the shareholder holding structure as any transfer of shares could trigger significant tax exposures and tax withholding liabilities.

6 15% preferential individual income tax in Hainan Free Trade Port (Hainan FTP)

On 23 June 2020, the Ministry of Finance and State Taxation Administration announced a Circular Caishui [2020] No.32 (Circular), which provided the individual income tax preferences in Hainan FTP effective from 1 January 2020 to 31 December 2024. According to the Circular, personnel with high-end and urgently needed skills working in Hainan FTP will be exempted from the portion of their effective individual income tax burden that exceed 15%. The above tax preference is applicable to individual's general income, income from business operation and income of talent subsidies recognized by Hainan Province.

The eligible individual LPs who have signed the employment contract with a company which is located and has business substance in Hainan FTP, and has continuously paid social security for more than 6 months (including December of the current financial year), is entitled to the 15% preferential income tax rate for the year.

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India tax developments

7 Cayman Islands being placed on the grey list of Financial Action Task Force (FATF)

The Reserve Bank of India (RBI) vide notification dated 12 February 2021 (Notification) has prohibited significant fresh investment (i.e., more than 20% voting power) in non-banking financial companies (NBFCs) (including housing finance companies and asset reconstruction companies (ARCs)) from and through countries which are classified/ re-classified as FATF non-compliant jurisdictions. This will however not impact existing or additional investment made by investors from such country if the investment was made prior to such re-classification.

FATF non-compliant jurisdictions are those which are (i) High-Risk Jurisdictions subject to a Call for Action, and (ii) Jurisdictions under increased monitoring.

Cayman Islands has been recently identified by FATF as jurisdiction under increased monitoring and was therefore placed under FATF's grey list.

Therefore, funds/ investors based in Cayman Islands (until Cayman Islands re-attains FATF compliant status) would not be able to make fresh significant investment (more than 20% voting power) in an Indian NBFC, housing finance companies or ARC.

Mauritius was also placed under FATF's grey list in 2020 and significant investment in Indian NBFCs (including housing finance company or ARCs) from and through Mauritius also face similar restrictions.

EU tax developments

8 Luxembourg: implementation of defensive measures related to countries on the EU list of noncooperative jurisdictions for tax purposes (the EU List)

With a law dated 10 February 2021, Luxembourg has introduced defensive measures towards countries listed on the EU List. The new law disallows, under certain circumstances, the deduction of interest and royalties owed by Luxembourg corporate taxpayers to associated enterprises that are corporations established in a jurisdiction that is on the EU List. The new provisions apply from 1 March 2021.

The new rule applies to interest or royalties that are owed, irrespective of whether they are paid or remain outstanding. This also means that interest or royalties that have accrued before the entry into force of the new law, i.e., before 1 March 2021, will remain deductible upon actual payment. The deduction of interest or royalties owed is denied when the beneficiary of the interest or royalties meets all of the following conditions. Where the beneficiary is not the beneficial owner of the interest or royalty, the criteria need to be assessed in relation to the beneficial owner:

- The beneficiary of the interest or royalties is a corporate entity as per the definition of Luxembourg Income Tax Law.
- The beneficiary is a related enterprise under the meaning of the Luxembourg transfer pricing provision.
- The beneficiary of the interest or royalties is established in a jurisdiction or territory that is on the EU List.

Even if the aforementioned conditions are all met, the provision will not apply if the taxpayer proves that the transaction that gives rise to the interest or royalties owed "is used for valid economic reasons which reflect economic reality." According to the parliamentary documents relating to the new law, it would not be sufficient to state economic reasons, but such reasons need to represent an economic advantage that exceeds a potential tax benefit resulting from the operation. No more details are provided as regards what kind of proof is expected or accepted to sustain that the transaction is effectively justified by valid commercial reasons.

PE investment structures should consider the wide-spread implementation of defensive measures in relation to jurisdictions on the EU List, especially as part of the respective PE funds being used for EU investments.

9 Global: Organization for Economic Co-operation and Development (OECD) on place of effective management during the COVID-19 pandemic

The COVID-19 pandemic may raise concerns about a potential change in the "place of effective management" of a company as a result of a relocation or inability to travel of board members or senior executives. Such a change may have a consequence on a company's residence under relevant domestic laws and may affect the jurisdiction where a company is regarded as a resident for tax treaty purposes.

Based on the view of the OECD, it is unlikely that the COVID-19 situation will create any changes to an entity's residence status under a tax treaty. Reasoning is that a temporary change in location of board members or other senior executives is an extraordinary and temporary situation due to the COVID-19 pandemic, i.e., such change of location should not trigger a change in treaty residence. There are also a number of jurisdictions that have reacted to the current circumstances and have issued guidance that temporary changes in work and company management practices resulting from the COVID-19 pandemic should not result in changes in the corporate residence (e.g., Ireland and UK).

9 Global: Organization for Economic Co-operation and Development (OECD) on place of effective management during the COVID-19 pandemic (cont.)

However, the current circumstances may trigger an issue of dual residence in cases where the change in the place of effective management results in a company being considered a resident of two jurisdictions simultaneously under their domestic laws. However, as recognized by the Commentary on the OECD Model, situations of dual residence of companies are relatively rare. But even in situations where there would be dual residence of an entity, tax treaties provide tie-breaker rules ensuring that the entity is resident in only one of the jurisdictions, whereby in most cases tax authorities deal with the dual residence issue on a case-by-case basis by mutual agreement.

This determination will take into consideration all of the facts and circumstances. Factors that are taken into consideration, inter alia, include where the meetings of the company's board of directors are usually held or where the senior executives usually carry on their activities. In conclusion, based on the OCED's view, an entity's place of residence under the tie-breaker provision included in a tax treaty is unlikely to be impacted by the fact that the individuals participating in the management and decision-making of an entity cannot travel due to public health measures imposed or recommended by at least one of the governments of the jurisdictions involved.

For relevant entities within private equity structures, e.g., as part of the holding structure, it might make sense to prepare respective documentation stating all relevant facts and circumstances for situations where the tie-breaker provision may be applicable as a result of the COVID-19 pandemic.

10 Germany: Government issues draft law on modernization of withholding tax relief and on changes to the anti-treaty shopping rules

On 20 January 2021, the Government agreed on a draft law proposing a modernization of withholding tax procedures. The draft is based on the first working draft issued by the Ministry of Finance. One of the key items is the proposed change to the German anti-treaty shopping rules. Such changes could in many cases tighten the current rules. The revised anti-treaty shopping rules would generally assume an abuse for any foreign recipient of relevant German-source income whose shares are not materially and regularly traded on a recognized stock exchange unless the absence of an abuse can be demonstrated.

Germany's attempts at creating a treaty-overriding anti-abuse provision received repeated pushback over the years as the European Court of Justice (ECJ) has consistently held such rules to be a violation of EU fundamental freedoms. The draft law now proposes a new approach that considers recent ECJ case law (the so-called "Danish cases") as well as Article 6 of the Anti-Tax Avoidance Directive (ATAD).

The wording of the new rule stipulates that a company has no claim for a relief from withholding tax under a tax treaty to the extent that it is owned by persons that would not be entitled for this relief, had they been the direct recipients of the income and the source of income is not materially linked to economic activity of this foreign company. The draft law makes it clear that receiving the income and an onward transfer to investors or beneficiaries cannot be regarded as an economic activity. The application of the above might be denied to the extent that the foreign company proves that none of the main purposes of its interposition is obtaining a tax advantage.

If this new rule becomes final law, it will in many cases require reconsidering current holding structures, in particular where the structures have so far relied on a look-through interpretation of the existing anti-treaty shopping rule. According to the explanatory notes to the draft, it could in the future be harmful for a holding company in country A to be interposed between a country B parent and a German income source even if both German treaties with countries A and B provide for the same WHT benefits. This is based on the fact that the entitlement would be based on different treaties and, hence, not "the same" entitlement. Such provisions could effectively narrow down the application of the look-through approach to European structures where all involved entities have access to EU directives and may require creating sufficient economic link between the German-source income and the economic activity at the level of the receiving (holding) entity.

Overall, the legislative developments of the draft law should be closely monitored as the included provisions may be a blueprint for other EU Member States for how to translate the ECJ doctrine on the Danish cases into law.

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