

Singapore's BEPS caution; Philip Baker's 'source vs residence' masterclass; MNCs face the heat!

Date : April 21 2015



The inaugural IFA Asia-Pacific Regional tax conference held in Singapore last week, promised a lot of fireworks and it did not disappoint! The two days conference witnessed high octane deliberations on some of the vexed international tax issues - BEPS and the changing tax landscape, Digital economy, anti-avoidance measures, latest trends in Asia-Pacific and recent developments in the world of transfer pricing.

The highlight of the two days conference was the key note talk on 'Source vs Residence', by renowned tax expert Philip Baker (QC), who not only gave a 360 degree perspective on the issue but also raised several thought provoking questions. The panel discussions also brought to the fore, countries like Korea, Indonesia and Australia turning the heat on MNCs even before BEPS comes into force.

Singapore's Senior Minister of State for Finance - Ms. Josephine Teo, however cautioned against unilateral, un-coordinated action and asserted that it is critical for tax reforms to accommodate "legitimate business models."

Special Address by Ms. Josephine Teo, Senior Minister of State, Ministry of Finance, Singapore:

In a brief but powerful address to the packed conference room, Singapore's Senior Minister of State for Finance, Ms. Josephine Teo alluded to the fast evolving international tax landscape and in this context, referred to the OECD's ambitious project - Base Erosion and Profit Shifting (BEPS). Ms. Teo stated that while the desire for quick action was understandable, she however cautioned against unilateral, un-coordinated action which according to the Minister, would only increase the business risk and impact cross-border trade. Ms. Teo asserted that it is critical for tax reforms to accommodate "legitimate business models."



Panel: Digital Economy Taxation

The panel chaired by **Mr. Stef van Weeghel (PwC Netherlands)** discussed the vexed issue of digital economy taxation. On creating direct tax "nexus" for digital economy, **Gary M. Thomas (Deloitte Tohmatsu Tax Co. Japan)**, dealt broadly with three approaches: 1) modification in existing Article 5(4), lowering threshold for PE, 2) formulation of new nexus based on "**significant digital presence**", which is contradictory to basic principles of 'physical presence' and 3) Virtual PE, which again departs from 'physical presence' norm. **Glen Hutchings (Australian Tax Office)** dealt with options to address broader tax challenges through withholding tax. **Tianlong Lawrence Hu (Renmin University of China)** focused his talk around the attribution of value to data, and determining the share of profit attributable to each function of collecting,



analysing and monetizing of data. He also shared China's strategy with regard to 'digital citizenship' as also the tremendous increase in online shopping in the most populated country in the world, which also posed a challenge to China's tax collection and administration. Mr. Glen Hutchings opined that "Formulatory apportionment is a slippery slope and not very effective".

Key-note address by Mr. Philip Baker on ' Source vs Residence Battle'

Without a shadow of doubt, the highlight of the two days conference was the key note talk on one of the oldest debates in taxation by renowned tax expert Philip Baker (**QC & Field Court Tax Chambers, Gray's Inn**) **who not only gave a 360 degree perspective on the issue but also raised several thought provoking questions.** Explaining concepts of residence, source and BEPS in detail, Mr. Baker posed a fundamental question ... "What should be the basis for a jurisdiction to impose income tax?" Quoting Public international law, Mr. Baker stated that "States have jurisdiction to impose tax if there is sufficient and legitimate nexus between the income / gains and the taxing jurisdiction". Mr. Baker laid down the dynamics favouring taxing rights to residence state viz. 1)The state of residence supplies social goods – education, health, security etc (in some countries) 2)The state of residence is best placed to assess ability to pay 3)The state of residence is best placed to collect tax on total income, and also laid down dynamics favouring taxing rights to source state viz.1) The state of source supplies the conditions in which the income is earned 2)The state of source is best placed to collect tax on local sources (by gross withholding at source). Mr. Baker then opined that a balance needs to be struck between source and residence.



Quoting the controversial Vodafone tax case of India (transaction with Hutchison) Mr. Baker again posed some vital questions and wondered if any of these points ought to make a difference to the final outcome on taxability of the transaction:

- That the state of the investor does not tax capital gains?
- That the host state is a developing country and needs revenue? (What does needing revenue mean?)
- That the asset was situated in a tax haven?
- That there is only an international exception for indirect transfers of land (and only land)?

Mr. Baker then enunciated the principle laid in *Government of India v Taylor* [1955] AC 491 – the *revenue rule*. It laid down a widely recognized principle of international law that one state will not assist directly or indirectly in the collection of taxes due to another. However, Mr. Baker pointed out that the principle in *Government of India v Taylor* is becoming widely eclipsed by arrangements for cooperation in tax collection and discussed the significance and implications of the demise of the *Government of India* principle. Mr. Baker stated that 1) The state of source can now find out about a non-resident's world-wide income, and tax on a net basis 2)Withholding taxes are no longer necessary, in principle and 3)Residence and source are no longer the only viable bases for tax jurisdiction.

Mr. Baker pointed to the world of Digital commerce wherein substantial profits can be earned without a Permanent Establishment. But he added in the same breath that broadening or abandoning the PE concept puts much more pressure on the identification of the source of business profits. Mr. Baker left the audience to ponder some basic questions that are rarely discussed:

- Why not tax individuals on the basis of citizenship?
- Why tax companies at all? Can corporate taxes be shifted to shareholders and workers? Do we therefore need to re-think the concepts of taxation of corporate profits and the concept of company residence?
- What ought to be the basis for jurisdiction to impose income tax? Some factors that could be considered are ease of collection and removal of tax barriers to trade and investment.



- Could one jurisdiction within a sub-continent collect taxes on behalf of other jurisdictions? Example - Could African nations outsource their tax collection and administration to South Africa, which possesses a modern tax administration?

Mr. Baker concluded his talk by making a forceful, passionate plea for smaller countries to have a seat at the table when these discussions are going on and asserted that " Might is not always right." He stated that the balance between source and residence should not simply be a matter of the claim of the most powerful but should also reflect inter-national equity. "he balance should encourage trade and investment, not damage them", concluded Mr. Baker.



Responding to Mr. Baker's key-note, IFA President Porus Kaka highlighted that in the 'overheated' BEPS debate, a crucial element was being ignored - taxpayer rights. He made a bold prediction that pendulum would swing back on the issue of taxpayer rights and that the last word had surely not been uttered on this subject. Mr. Kaka then referred to UK's controversial Diverted Profits Tax legislation and stated that the same was actually diluting the concept of legal PE. He wondered if other countries too might be inspired by the UK example and might follow suit...

Mr. Kaka however had a contrarian take on the dominance of the bigger economies in this entire exercise and stated as a matter of fact that " Might is going to be right..." He added that the market share of larger countries will continue to

be relevant in the influence they exercise and quipped that " Market share represents the significant base that they (bigger economies) don't want to erode. "

Panel: Hot topics in Asia-Pacific (China, Singapore, Japan)

This session, chaired by Eric Roose (Morrison Foerster) turned its gaze on the hot-topics in Asia Pacific, of which there were plenty. Panelist Peter Ni (China) took the audience through the macro economic scenario in China and drove home the point that the otherwise buoyant tax revenue growth in China had shown a remarkable slowdown in 2014, clocking just 8.8% additional tax revenues in 2014 as opposed to a 20% YoY average for last 2 decades. This, according to Mr. Ni, would mean stepping up of anti-avoidance effort, strict tax administration and more tax audits. He also discussed the latest on circular 698 (dealing with indirect transfers) whereby the mandatory reporting requirement has been now made optional, a group-transfer relief introduced for the first time and the taxable scope expanded to include PE assets and immovable properties in China. On inter-company payments, Mr. Peter Ni discussed Bulletin 16 introducing new specific rules on cross-border inter-company payments as per which disqualified payments (including stewardship and royalty payments) are not deductible. Mr. Peter Ni also discussed incentives in China on property exchanges. On the evolving outbound investment taxation scene in China, Mr. Ni brought out some salient features:



- 1) Chinese CFC rules are really undistributed earning tax and no case has been reported so far.
- 2) Both direct tax credit and indirect tax credit allowed but limited to three tiers.
- 3) Deemed Chinese tax residency rule is more commonly used than CFC rule
- 4) Ownership of 10% or more in a foreign entity and any increase or decrease should be reported annually.

Fellow panelist **Pieter de Ridder (Mayer Brown)** touched upon recent developments in Singapore/Hong Kong/ Indonesia. He talked about the Hybrid instruments in Singapore, provided comparison of private equity funds in Hong Kong vis-à-vis Singapore and also discussed the favourable Hong Kong – Indonesia treaty. **Eric Roose** threw light on some interesting development in Japan, especially the reduction in corporate tax rates from the peak rate of 42% to 33.10% and further anticipated that same may further come down to 27%.

Panel: Transfer Pricing developments in the Region

The panel, chaired by Mukesh Butani (BMR Legal, India) focused on the latest trends in Transfer Pricing in the Asia-Pac and some of the facts and figures were surely a revelation. The panel showed the ' Big Picture' to the audience, encapsulating some emerging trends and how the transfer pricing landscape will pan out over the next 18-24 months:

- Tax authorities view multinationals as potential sources of additional revenue for national budgets.
- Some high profile multinationals may have been overly aggressive in their transfer pricing systems and practices.
- Taxation of multinationals has become a political and media issue.
- Jurisdictions will continue to use tax and incentive regimes to compete for investment from multinationals.
- BEPS actions will not be implemented fully or consistently by all jurisdictions.
- Misalignment of tax rules will remain.
- Multinationals will face greater level of disputes in the future.

The panelists then drew the attention of the audience to individual country highlights. Mr. James (Korea) talked in detail about the aggressive transfer pricing assessments by Korean tax authorities, which he attributed to the shortfall in tax collection. He also shed light on the Advance Pricing Agreements (APAs) being subjected to rigours of increased scrutiny, thereby leading to decline in APA applications. He then concluded that a combination of aggressive taxation, increase of disputes, and difficulty in dispute resolution is making it difficult for MNCs to operate in Korea.



Mr. Douglas Fone painted a similar, grim picture of the tax landscape in Indonesia, which as per him, carried a high risk of double taxation for MNCs. He also lamented the slow MAP & APA process and his parting lines were surely not music to the ears of those planning to do business in Indonesia - that the TP audits would increase in both number and 'severity' in the current year. Turning to Australia, Mr. Fone did not have much better news from down under. He told the audience that the Australian Tax Office (ATO) is sending 'aggressive' message to MNCs and is under domestic pressure to enact unilateral, protectionist measures vis-a-vis BEPS project. On this score, the ATO is carrying out extensive audit activity vide its International Structuring and Profit Shifting (ISAPS program). The panel was told that as part of this program, the ATO had placed the 69 largest companies in Australia under "24/7" review and that there are currently 100 issues in dispute with these companies.

The panel also had some practical suggestions for MNCs to reduce their TP exposure:

- Design transfer pricing systems so that profits are aligned with value creation
- Monitor performance and identify risks early
- Ensure that TP documentation and economic analysis is prepared and up- to-date
- Anticipate the increased level of scrutiny and transfer pricing disputes
- Consider the available dispute resolution strategies
- Be prepared to "amend or defend"
- Pick your battles and exercise tailored options of resolution
- APA's can bring certainty to investment strategy
- Walk the talk - Conduct of business is as important as the contracts and documentation

Panel: Anti-avoidance developments in Asia-Pac region

Further, the conference witnessed a session on anti-avoidance developments in Asia-Pacific region, chaired by Dr. **Parthasarathi Shome** (Former Advisor to Indian Finance Minister) who took the delegates through GAAR, SAAR and CFC developments in India. He started the discussion by showing comparative GDP figures of China, Brazil and India. He showed how China has been consistent in its growth over few decades and how Brazil started at the high growth rate of China and came down to India level over decades. He enunciated the recent, changed philosophy of Indian Revenue authorities who are making reduction in tax revenue projections as against the inflated projections before. This shows that India is now projecting tax revenues on realistic terms and is slowly moving away from recovering tax through undue means, stated Mr. Shome. **Kim Jecino**



(Philippines) shared that indirect transfer is a growing issue in Philippines. Further, the panel was informed about no interest deductions to intermediaries in Philippines. With regard to EOI, he remarked that in Philippines if you 'transfer' without intimating, it's a criminal offence. Further, Philippines is very strict about documentation. Example - if you don't produce receipt recognized by Philippines, then you don't get a deduction. **Sataru (Japan)** shared that Japan doesn't have separate anti-avoidance rule, but it is inbuilt in its domestic Act. Further, **Mr. Seal Lee (Korea)** stated that tax administration in Korea is responsible for determining transactions avoiding tax.

Panel: Indirect transfer rules in India, China & ASEAN Countries

A panel comprising of **Jan de Goede (IBFD, Netherlands)**, **Aliff Fazelbhoy (India)**, **Aurobindo Ponniah (Malaysia)** and **Peter Ni (Zhong Lun, China)** discussed the indirect transfer rules in India, China and ASEAN countries and recent development in domestic taxation and tax treaties. On indirect transfers, **Mr. Aliff Fazelbhoy**, divided the discussion into broadly 5 parts, i.e. the Vodafone case, changed position owing to retrospective amendment by Finance Act, 2012, current position proposed by Finance Bill 2015, availability of tax treaty benefits and issues yet to be resolved (e.g. Rules for computation of 'value' for indirect transfers are yet to be prescribed by CBDT). **Mr. Peter Ni** took the panel through the history of indirect transfer rules in China stating that the 2008 Enterprise Income Tax Law introduced the general anti-avoidance rule for the first time in China. Further, he stated that Circular 698 was issued in Dec, 2009 to specifically deal with offshore indirect transfers of Chinese enterprises and also codify the Chongqing case decided by the local tax authorities in 2008. He updated the audience on Bulletin 7 that was issued in Feb, 2015 to replace Circular 698 to the extent of indirect transfers and provided a comparative analysis of circular 698 vs Bulletin 7. On implementation part, he stated that there are no judicial cases so far, including treaty based case in China and that China is very aggressive on making decisions. He also informed the gathering that it is still up in the air on how the withholding obligation rule will be implemented by China. Similarly, **Mr. Aurobindo Ponniah**, educated the panel on the developments in ASEAN countries. He stated that most of the countries do not have specific rules on the taxation of indirect transfer of assets but some do have anti-avoidance measures which could be used if a transaction is thought to be abusive. Further, panel was informed that Malaysia & Singapore do not impose tax on capital gains (other than real property), while Indonesia, Philippines, Thailand & Vietnam do tax capital gains (either as capital gains or revenue). He also shared the nascent steps taken by Indonesia and Vietnam in addressing the issue of indirect transfer taxation.