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Asia pacific private equity tax
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Insights into topical tax issues, trends and developments in the private equity industry throughout the Asia pacific region

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Introduction

Welcome to our fourth edition of Asia pacific private equity tax.

I do hope you find this edition useful reading for planning and monitoring your private equity investments througout the region. As always, please feel free to contact any of our specialist authors listed, our country leaders or your usual PwC contacts to discuss any of the matters raised in this edition.

With warmest regards

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In 2012, we began with the level of commitments and transactions trending downwards throughout the region, partly attributable to the European debt crisis and fears of China's slowing down, at least in terms of exit/IPO access. However, deal activity in the region proved comparatively resilient, with marked increases expected through 2013 and a number of encouraging transactions that closed towards the end of last year and the start of this.

China, Japan, India, Korea and Australia maintained their position as major investment destinations in the region, with these markets expected to continue to attract significant investments and generate the major portion of capital returned. Our specialist authors provide insights into the latest developments in these five markets, including China's draft supplementary on Circular 698, India's key Budget proposals impacting private equity investments, Korea's liberalising the tax regime for foreign tax exempt investors in Korean private equity funds, an update on Australia's views on the appropriate tax treatment of gains derived by foreign private equity investors, and Hong Kong's extension of its safe harbour rule to private equity funds. We close with a market analysis of an encouraging recovery in Japan by our guest author, the Asia Private Equity Research Ltd's Kathleen Ng.

2012 also saw a rise in the importance of new markets with their promising growth perspectives as well as their relative resilience in times of global market uncertainty; and this trend is expected to continue. This edition provides an update on two of these most promising markets, Myanmar and Indonesia. Indonesia has been the leading investee market in South East Asia and continues to attract investors with its population and abundant natural resources. Our article looks at the attractive features of the new Indonesia-Hong Kong tax treaty as an investment platform. With the opportunities created by its re-opening, investors are starting to take a closer look at Myanmar. Our article sets out opportunities for private equity investors and discusses possible investment structures, including comments on financing, profit repatriation and exit strategies.

Following our round trip through emerging and developed Asia, we address a number of issues to be considered over the coming year in our special features section, setting out the US taxation of non-resident capital gains (where, by comparison with some Asian tax regimes that tax non-residents on capital gains, gains realised on the sale of US securities arising to non-residents are generally not subject to US tax), introducing transfer pricing issues in connection with carried interest and identifying trade compliance as a review area for due diligence. As recommended additional reading, we would also like to draw your attention to our recent paper on the key investment trends and tax risks associated with investments by sovereign investment funds.[1]

1 http://www.pwc.com/jp/en/tax-publications-financial-services/sovereign-investment-funds-dec2012.jhtml

Myanmar
A new wave rising

The inauguration of a civilian government in 2011 ended five decades of military rule on Myanmar's centrally planned, virtually closed economy.

Support from the international community is strong, clearly seen through the easing, suspending and lifting of sanctions on trade and investment. With this support and the strong desire of the Myanmar Government for reform and change for the betterment of its people, coupled with the many strengths of and opportunities in the country with its upbeat near term economic outlook of GDP growth at 6.3% in 2013[1], Myanmar has a strong foundation to provide for growth and success.

Many investors are realising the immense potential held in this emerging market once isolated from the world.

Figure 1 Strengths, weaknesses, threats and opportunities

Strengths

- Abundant natural resources
- Large youthful low cost labour
- Changing legislation to promote growth
- Strategic location bordering two of Asia's largest developing economies – China and India
- Attractive tourist destination
- Changing legislation to promote growth

Weaknesses & constraints

- Deficient infrastructure
- Limited industrial diversification
- Inadequate social services that in turn hamper human capital development
- Insufficient fiscal resources
- Inefficient domestic fund mobilisation
- Limited access to working capital for businesses

Threats

- Political tensions
- Social tensions
- Long running ethnic conflicts
- Civil wars
- Sanctions that continue to be in place

Industry opportunities

- Resource & energy
- Infrastructure
- Information & communications
- Real estate
- Tourism
- Consumer industrial products & services
- Retail
- Financial services

1 IMF World Economic Outlook 2012.

Put together, the strengths as highlighted in Figure 1 set the stage for Myanmar's future growth and success. The weaknesses and constraints identified may look daunting, however, if strategically leveraged upon in tandem with the country's strengths, they can provide a vast array of opportunities for foreign investors in Myanmar.

Most importantly, the changing legislative environment is aimed at promoting growth in Myanmar through the liberalisation of markets and providing access for foreign investors to invest and improve the economy and lives of the people.

Myanmar Foreign Investment Law

The new Myanmar Foreign Investment Law (**MFIL**) approved by the Myanmar government and the President on 2 November 2012 sets out land-use terms, legal structures and incentives for foreign companies, such as a five-year tax holiday from the start of commercial operations, demonstrating the government's commitment to attract long term foreign investment. Recent updates to the MFIL on 31 January 2013 have seen the government liberalising various sectors previously tightly controlled and closed to foreign investors. For example, foreign investors can now participate in the country's retail industry through a joint venture with at least 40% local participation, subject to conditions. An extensive list has also been issued providing the type of foreign investments allowed in the form of joint ventures with Myanmar citizens with minimum shareholdings of 20%.[2]

To obtain an investment permit from the Myanmar Investment Commission (**MIC**), a foreign investor must submit to the MIC a proposal in a prescribed form together with supporting documents and justifications. The MIC will assess whether the proposed investment by the foreign investor is in line with the policies, rules and regulations set by the government. It is required to assess the appropriateness of technology, financial credibility and economic justification of the business venture described in the proposal. A permit is granted based on certain terms and conditions. Upon approval from the MIC, a company registered under the MFIL will be entitled to a five-year income tax holiday and various other incentives. The MIC will monitor and evaluate the investment situation and, where necessary, amend the terms and conditions previously defined.

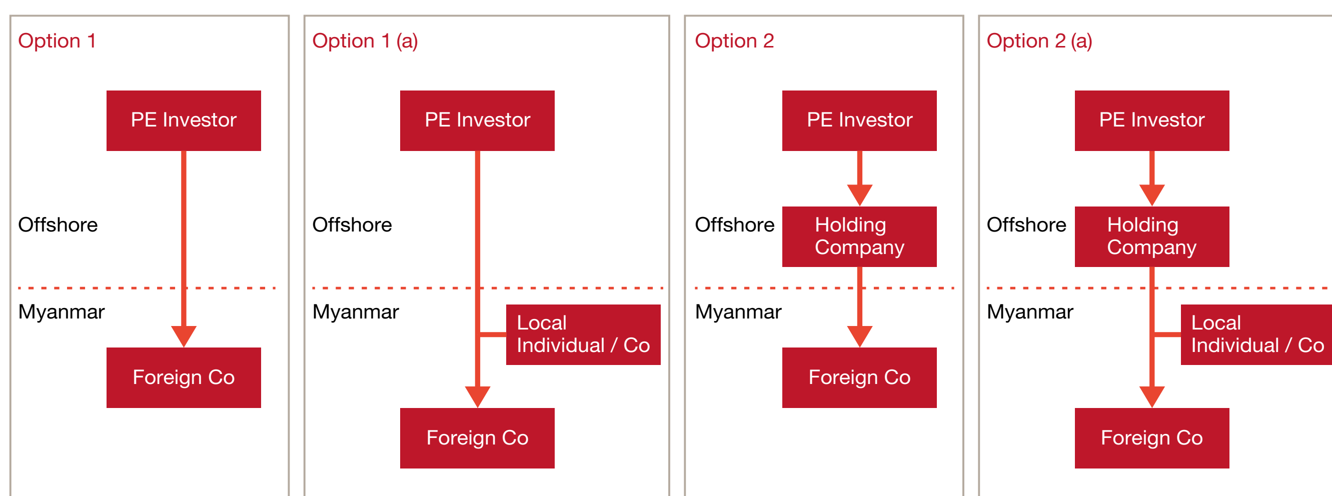
Your entry into Myanmar

A foreign investor may carry out its operations in various forms of entities in Myanmar. Types of entities that are more relevant to foreign investors include a private limited company that could be incorporated and registered under the Myanmar Companies Act (**MCA**) or the MFIL, a branch office or a representative office. Each type of entity has its own pros and cons, in terms of the tax, regulatory and operational perspectives. A company incorporated under the MCA and MFIL with any shareholdings by foreign investor(s) will be regarded as a foreign company in Myanmar (**Foreign Co**).

Figure 2 depicts some possible investment structures in which a private equity investor (**PE Investor**) can look to invest into Myanmar.

2 Examples include construction related to development of rail/road links, manufacturing raw materials for drugs, etc.

Figure 2 Holding structures



For investments in specified industries that require a local shareholding, a PE Investor has little choice but to opt for either Option 1(a) or Option 2(a) where the Foreign Co needs to be jointly held by one or more Myanmar nationals or a company incorporated in Myanmar that is owned by one or more Myanmar nationals only (**Local Individual / Co**). Subject to commercial considerations and legal requirements, in determining which holding structure is more tax efficient and beneficial, we consider the following three major issues – profit repatriation, exit strategy and tax treaty network.

Myanmar has signed tax treaties with ten countries, including Bangladesh, India, Indonesia, Laos, Malaysia, Singapore, South Korea, Thailand, Vietnam, and the United Kingdom. A foreign PE Investor may envisage the use of tax treaty when deciding its investment structures into Myanmar (i.e., Option 2 and Option 2a above). For example, most foreign investors are holding their subsidiary companies in Myanmar through a holding company that is resident in Singapore.

A foreign investor could be subject to capital gains tax on the gains derived from the sale of shares in a Foreign Co incorporated in Myanmar at the rate of 40% in Myanmar. However, under the Myanmar-Singapore tax treaty, the Myanmar capital gains tax could be exempt or reduced to a 10% rate, subject to the satisfaction of conditions under the treaty. What is not quite tested is whether the Myanmar authorities would allow the Local Individual / Co to co-invest by holding shares where the Holding Company is incorporated outside Myanmar.

A company wholly owned by Myanmar individuals or entities is regarded as a Myanmar Company (**Myanmar Co**). It should also be noted that the transfer of shares in a Myanmar Co to a foreigner is restricted. The acquisition of shares in a Foreign Co registered under the MCA or MFIL is allowed, subject to MIC approval.

Where a Myanmar Co is the likely subject of an acquisition it is more likely that the acquisition will involve an asset deal where a new company is incorporated in Myanmar as a Foreign Co. The Foreign Co will acquire the relevant assets from the Myanmar Co. Generally, an asset acquisition is also preferred in Myanmar due to the difficulties in determining the undisclosed liabilities such as unpaid taxes or other unrecorded liabilities of a target company. However, the Myanmar Income Tax Act allows the Myanmar tax authorities to impose tax on the successor of a business if there is difficulty in communicating with the previous owner. As the term "business" is not clearly defined, it can be interpreted literally to include an asset transfer (not just a share transfer).

Financing of investment

There is a minimum capital requirement for the establishment of a company, a branch or a representative office in Myanmar. The minimum capital is USD150,000 for a manufacturing company and USD50,000 for either a service company, a branch or a representative office. If a foreign investor wishes to register its subsidiary company under the MFIL, the minimum share capital will be determined by the MIC upon the submission of an investment proposal by the foreign investor on a case by case basis.

Where a company requires a special licence from the government, the relevant regulatory bodies may require certain ratios between the level of paid-up share capital and any debt which may include shareholder loans.

Interest expenses are deductible for tax purposes in Myanmar to the extent that they have been incurred in the production of taxable income. There are currently neither transfer pricing rules nor specific safe harbour rules with respect to a debt to equity ratio in Myanmar. Generally, a payment made to any related parties which are not commensurate with the volume of business or benefits that the local company received will not be tax deductible.

Profit repatriation and exit strategies

Profit repatriation

If a PE Investor decides to inject equity capital into Myanmar and the company subsequently distributes dividends, such dividends made to the investor should not be subject to any Myanmar withholding tax. Where capital is injected into the Foreign Co in the form of a shareholder's loan, subsequent interest payments to its shareholder(s) will be subject to Myanmar withholding tax at the rate of 15%. This rate may be reduced under an applicable tax treaty, subject to conditions. For example, the withholding tax rate on interest payments is reduced to 10% under the Myanmar-Singapore tax treaty.

Generally, before a Foreign Co may distribute dividends or interest to its foreign shareholder(s), the company must obtain an approval from the Central Bank of Myanmar through an application together with the supporting documents. If the Foreign Co is formed under the MFIL, approval of the MIC is also required.

Exit strategies

Under Option 1, where a PE Investor disposes of the shares it holds in the Foreign Co directly and derives gains from the sale of shares, the PE Investor being a non-resident foreigner could be subject to capital gains tax at the rate of 40% in Myanmar. On the other hand, where the PE Investor divests its Myanmar investment through the disposal of shares in the Foreign Co by the intermediate holding company (as illustrated as Option 2 and Option 2a above), the PE Investor through choosing a tax efficient holding company location may avail itself to the relevant reduced capital gains tax treaty rates, subject to conditions. Further, the investment structure involving the use of an offshore holding location will provide a PE Investor with a flexibility in deciding the level at which it will exit from the investment in Myanmar (i.e., it can choose to dispose of shares in the holding company or have the holding company dispose of shares in the Foreign Co).

Are you ready?

Myanmar is one of the last new economic frontiers. The country's return into the global economy has given the international community a glimmer of hope in an otherwise gloomy period. The many new measures that the government is rolling out are strengthening the attraction of foreign investors into the country.

*After a decade of absence, PwC returned to Myanmar with the incorporation of PricewaterhouseCoopers Myanmar Co., Ltd (**PwC Myanmar**) in October 2012 and the opening of its physical office in Yangon on 6 November 2012. PwC Myanmar now offers a comprehensive suite of business services to assist our clients in investing and doing business in Myanmar. Our team comprises experienced local professionals with a deep knowledge of the intricacies of the country, who are well versed with the complex regulations there, yet have overseas work experience and thus operate at international standards of business. This team is enhanced by the expertise, resources, research capabilities and thought leadership of PwC Singapore.*

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Indonesia
New Indonesia-Hong Kong tax treaty

Indonesia-Hong Kong tax treaty comes into force

On 21 November 2012, the Director General of Taxes (**DGT**) finally issued a circular (SE-50/PJ/2012) announcing the entry into force of the Indonesia-Hong Kong tax treaty, which will take effect from 1 January 2013 and 1 April 2013, in Indonesia and Hong Kong respectively.

This tax treaty contains attractive features when compared with other treaties Indonesia has concluded, as summarised below:

1. In the absence of a tax treaty, Hong Kong residents receiving income (dividends, interest, royalties and service fees) from Indonesia not attributable to a permanent establishment (**PE**) in Indonesia are subject to a 20% withholding tax (**WHT**). Under the treaty, this rate will be reduced to 10% for dividends. If the recipient is a company holding at least 25% of the share capital of the Indonesian company paying the dividends, the WHT rate will be further reduced to 5%. The WHT for royalties and interest will be capped at 5% and 10% respectively.

2. Fees from services will be exempt from Indonesian tax if in performing the services no PE is created in Indonesia. According to Indonesian tax law, where services are performed (by employees or other parties) in Indonesia for more than 60 days within a 12-month period a PE arises in Indonesia whereas under the treaty a service PE is defined to include the provision of services by an enterprise if the services continue (for the same or a connected project) for a period or periods aggregating more than 183 days within any 12-month period.

3. In Indonesia, branch profits are subject to the ordinary corporate tax rate and the after-tax profits are further subject to branch profit tax (**BPT**) at a 20% rate. Under the treaty, the BPT is capped at 5% of the after-tax amount (except for production sharing contracts in the oil and gas industry and contracts for works in the mining industry). In addition, in the absence of a treaty, profits of a Hong Kong company conducting business through a branch in Indonesia will be double taxed if the profits derived by the branch are also regarded as Hong Kong sourced and therefore taxable in Hong Kong. Such double taxation is avoided by means of a tax credit under the treaty.

4. Under domestic Indonesian tax law, transfers of shares in non-listed Indonesian companies by non-residents are subject to WHT equal to 5% of the gross sale value. However, under the Indonesia-Hong Kong tax treaty gains derived from the alienation of shares in a company that does not derive 50% or more of its asset value directly or indirectly from immovable property owned by the company and

located in the other country, regardless of the percentage of shareholding and the holding period, are exempt from tax. Capital gains derived from the transfer/sale of shares in a property holding company may be taxed under the treaty, except in the case that the transfer is made in the framework of a reorganisation; or the immovable property held is used to carry on the business (such as a mine or a hotel).

As Hong Kong only taxes Hong Kong sourced profits, there is a concern that certain income (including dividends, interest and royalties) which is regarded as non Hong Kong sourced and non-taxable in Hong Kong will not be able to satisfy the "subject to tax" requirement in the stipulated Certificate of Residence (referred as **DGT-1 Form**) and will not be entitled to reduced WHT rates. On various occasions, the DGT in principle supported implementation of the Indonesia-Hong Kong tax treaty. However, in relation to the administrative requirements in Indonesia, further guidance from the DGT needs to be monitored, including how to complete question 11 of Part V (confirming the earned income is "subject to tax" in Hong Kong) of the DGT-1 Form for non-banks and unlisted companies.

Latest development in re-audit

Although the General Tax Provision Law stipulates that an additional tax assessment can be issued after a re-audit is conducted only if there is new data, the Minister of Finance Regulation (**PMK-199**) stated that a re-audit could also be conducted based on DGT's consideration, i.e., there is a discretionary element. The provision in PMK-199 therefore created uncertainty for taxpayers in regard to the possibility of being re-audited. A new Minister of Finance Regulation (PMK-17), effective since 1 February 2013, clarifies that a re-audit can be conducted only if there is new data, including data not previously disclosed.

Potential tax implications of the alignment of Indonesian Accounting Standards with IFRS

The Indonesian Accounting Standards have been aligned as much as possible with IFRS, albeit with certain modifications. Despite the fact of this IFRS alignment, tax laws and regulations have not considered nor have been updated for the changes in the Indonesian Accounting Standards. This creates many potential tax issues arising from the changes in the Indonesian Accounting Standards. Currently, the position taken by the DGT is that:

- For tax treatment specifically governed in tax regulations, they should follow the tax regulations.
- For those that are not specifically governed in tax regulations, the tax treatment should follow the accounting treatment.

Due to the changes in accounting treatment on certain transactions, careful consideration on the tax implications should be sought.

Potential regulation on debt to equity ratio

Although under the prevailing income tax law the Minister of Finance is authorised to determine the ratio of debt to equity of a company for the purpose of calculating tax due, no implementing regulation has yet been issued to further govern this ratio. However, recently there have been intensive discussions that the DGT may soon issue a regulation on the debt to equity ratio. Accordingly, developments should be closely monitored.

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China

Draft supplementary rules on Circular 698 in relation to indirect equity transfers

In December 2009, the State Administration of Taxation (**SAT**) issued a circular, Guoshuifa [2009] No. 698 (**Circular 698**), requiring a non-tax resident enterprise (**non-TRE**) to report an indirect transfer of equity of a PRC tax resident enterprise (**TRE**) within 30 days upon the transfer of the offshore holding company (**SPV**), if the SPV is located in a low tax jurisdiction (with an effective tax rate of less than 12.5%). If the Chinese tax authorities consider that the SPV is interposed for the main purpose of avoidance of Chinese withholding income tax (**WIT**), it could invoke the general anti-avoidance rule (**GAAR**) to challenge and levy WIT on the gain derived by the non-TRE on the indirect equity transfer.

The SAT has become aware that Circular 698 and China's GAAR rules may create uncertainties to foreign investors in various areas, including internal group restructuring that involves the indirect equity transfer of group companies in China with genuine business reasons, cost basis for the indirect equity transfer, types of transaction to be reported, etc.

In response to the above, the SAT has been working on a draft supplementary circular to clarify various issues in the following areas:

a) Safe harbour rule

An indirect equity transfer in the course of internal group restructuring by a non-TRE would be regarded as a transaction having reasonable commercial purpose if all of the following three conditions are satisfied:

1. The ownership relationship between the foreign transferor and the foreign transferee in the transaction exceeds a certain prescribed threshold;
2. The percentage of equity interest held by the multinational group in the TRE has not changed before and after the internal group restructuring; and
3. The internal group restructuring does not result in a change of the effective WIT burden on the capital gains arising on the subsequent sale of the equity interest in the TRE.

b) Determination of the cost basis for an indirect equity transfer

We understand that the SAT is considering that for a foreign seller of an indirect equity transfer transaction who previously purchased the SPV's shares from another foreign company (i.e., the previous seller), if the previous seller has already settled the WIT on the previous indirect equity transfer transaction (or the transaction is exempted from WIT in accordance with the relevant Chinese tax regulations), the seller can adopt its actual purchase cost as the cost base for calculating the gain on a subsequent indirect equity transfer, in case the transaction is subject to a GAAR challenge. Otherwise, the SAT may not allow the seller to step up its purchase cost base for calculating the gain on an indirect equity transfer for WIT purposes.

c) List of unfavourable factors

The supplementary circular will also set out some unfavourable factors that will likely trigger a GAAR challenge on an indirect equity transfer transaction as follows:

- If the offshore SPV only has a business registration in the country of incorporation but does not carry out production, distribution of products, management functions, etc.
- The sale consideration is mainly determined based on the valuation of the TRE or Chinese immovable properties.
- The share purchase agreement clearly indicated that the actual purpose of the transaction is to transfer the TRE or Chinese immovable properties.

It is obvious that the SAT officials are fully aware of the shortcomings and difficulties of the enforcement of Circular 698, with the supplementary circular intended to improve this situation. This being said, the supplementary circular may also create new challenges for foreign sellers, such as determining the cost basis, analysis of the application of unfavourable factors, etc. However, as the final rules have not yet been issued, there may be subsequent changes.

China
Time to consider investing in Qianhai?

In China's 12th Five Year Development Plan (2011 to 2015), Qianhai Modern Services Industry Cooperation Zone (**Qianhai**) in Shenzhen is one of the three zones being earmarked as key strategic development areas in the Pearl River Delta in Southern China. On 27 June 2012, the State Council officially released its approval, under a notice Guohan [2012] No. 58 of the preferential policies and tax incentives granted to support the development of Qianhai.

The tax incentives offered in the notice include:

Financial services is a key industry that Qianhai would like to develop in its zone. We understand that apart from the above mentioned tax incentives, the Qianhai government is considering various innovative policies to attract private equity and asset managers to invest into their zone. This being said, it is also critical to put in place appropriate business and operational models as well as human resources mobility strategies to leverage the potential tax and financial incentives.

Taxes	Preferential Treatment
Corporate Income Tax (**CIT**)	Qualified enterprises (i.e., enterprises that fall within the upcoming Catalogue for Encouraged Industries in the area) shall be eligible for a reduced CIT rate of 15% on their taxable profits.
Individual Income Tax (**IIT**)	Overseas "talents" and "professionals in short supply" (collectively "qualified expat talents") working in Qianhai will receive an IIT rebate from the Shenzhen municipal government so that their effective income tax burden will be equalised to what they should pay if they worked overseas and such rebate shall be exempt from IIT.
Business Tax (**BT**)	Qualified logistics companies that are registered in Qianhai are allowed to apply a net basis for BT reporting.

In February 2013, China's National Development and Reform Commission approved the "Catalogue for the Industries Allowed in Qianhai of Shenzhen". This catalogue sets out the industry sectors that are allowed to arrange the establishment in Qianhai.

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India
Key Budget proposals impacting private equity investments

With the backdrop of a decelerating growth rate, concerns about the rising current account deficit and apprehensions raised by the offshore investor community in respect of some high profile tax amendments introduced last year, the Indian Finance Minister (**FM**) was in an unenviable position when he was reappointed in July 2012. However, what the FM has delivered in the past eight months or so is commendable, whether by way of constitution of an Expert Committee to initiate discussion with stakeholders on tax issues, holding road shows to address the concerns of offshore investors or other reform measures announced in the last few months. In fact, this led to wide anticipation of a "dream budget" from the FM as he had presented in the past. However, the FM chose to adopt a more balanced and cautious approach as he presented his Budget proposals.

This article seeks to discuss the key Budget 2013 proposals impacting offshore private equity investments into India.

1. General anti-avoidance rule

The general anti-avoidance rule (**GAAR**) proposals were introduced in last year's Budget. The provisions were sought to be effective for income arising on or after 1 April 2013. The manner in which the provisions were introduced raised concerns among the offshore investor community. To address some of these concerns and accepting the recommendations made by an Expert Committee constituted by the Government, the FM proposed to defer GAAR to income arising on or after 1 April 2015.

While the FM has refrained from expressly including provisions grandfathering gains on existing investments in the Budget proposals, in an earlier announcement, the Government had indicated that gains on investments made prior to 30 August 2010 would be grandfathered. This aspect and certain other details may be included as a part of the detailed GAAR guidelines to be issued by the Department of Revenue.

The larger takeaway is that GAAR, in the Indian context, is a certainty and offshore private equity investors should consider the impact of GAAR provisions on their investments.

2. Offshore transfers

It was widely anticipated that the FM would clarify the ambit of the offshore transfer provisions introduced last year, seeking to tax offshore transfers (as in the *Vodafone case*). These provisions are particularly relevant in the context of India-focussed offshore funds and offshore SPV/holding structures. However, the FM refrained from providing any clarifications. After the Budget, a media report also quoted the FM as stating that Vodafone had proposed conciliation of the pending tax litigation and an appropriate time to go to Parliament would be after resolution of the Vodafone case. Thus, the ambiguity on the applicability of these provisions may continue for some more time.

Offshore private equity investors need to be mindful of these provisions at the time of investing and divesting, repatriation of cash to their investors as well as with transfers of LP interests.

3. Tax on buyback of shares

With an objective of countering the tax mitigation strategy of repatriating profits by way of buyback of shares, the FM has proposed to shift the potential incidence of taxation in a buyback from the investor to the investee company. In a buyback, tax at 20% is now proposed to be levied on the investee company on the difference between the consideration received by the shareholder as reduced by the amount received by the investee company for issue of such shares. Buyback proceeds will be exempt in the hands of the shareholder.

While the FM has been innovative in proposing the levy, there are certain subtle points and interpretation issues that need closer examination.

4. Tax residency certificates

An obscure proposal created a scare among offshore investors, especially portfolio investors. It was proposed that a tax residency certificate (**TRC**) would be "necessary but not sufficient" to claim treaty benefits. This could have had the effect of unsettling a settled position that a TRC, especially in the context of Mauritius tax residents, is adequate to avail treaty benefits. The stock markets adversely reacted to the proposed change prompting a clarification the next day from the Department of Revenue to the effect that the current position, i.e., that a TRC would not be questioned, remains valid, and this would be addressed at the time of enacting the Finance Bill.

While there were no major tax proposals in the Budget and the FM could have aimed for more, at times, as the cliché goes, "no news is good news".

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Korea
Liberalising the tax regime for foreign tax exempt investors

Background

Although a local private equity fund (**PEF**) regime was introduced in Korea in 2004[1], Korean PEFs have not been the vehicle of choice for non-Korean private equity firms due to various restrictions and disclosure requirements under the Korean PEF law.

From a tax perspective, a major limitation of using Korean PEFs was that the underlying income of a Korean PEF is re-characterised as a dividend upon distribution by the Korean PEF.[2] This meant that underlying capital gains on the sale of shares, which may have been potentially exempt under a tax treaty if the Korean investment was held directly by an offshore PEF, would be subject to Korean tax as a dividend.

The re-characterisation of the capital gain as a dividend meant a Korean tax leakage ranging from 5% to 15%, which eliminated the use of a Korean PEF as a viable option, especially where the cornerstone investors were tax exempt in their home countries, such as, for example, US pension funds.

Recent tax law amendment

In order to remove the difference in the Korean tax outcome for foreign tax exempt investors investing into Korea through a Korean as opposed to an offshore PEF, and thereby promoting the use of Korean PEFs, the Korean government recently amended the tax law to allow a full "look-through" treatment for underlying income of a Korean PEF for qualifying foreign tax exempt limited partners (**LPs**) in a Korean PEF.

Under the tax law amendment, foreign LPs in a Korean PEF may be entitled to a full look-through treatment on the underlying income (as opposed to a dividend treatment), and thus be potentially able to claim an exemption from Korean taxation on the underlying capital gain under an applicable tax treaty, if all of the following conditions are met:

1. The LP is a resident of a country which has a tax treaty with Korea;
2. The LP is one of the following:
   - A sovereign wealth fund,
   - A regulated pension fund established under a law similar to the Korean National Pension Act, Public Officials Pension Act, Armed Forces Personnel Pension Act, Pension for Private School Teachers and Staff Act, or the Guarantee of Workers' Retirement Benefits Act,
   - A non-profit organisation which does not distribute profits to its members; and
3. Income received from the Korean PEF

1 Refer p. 36 of the 2011 issue of Asia pacific private equity tax for a more detailed outline of the Korean PEF regime. http://www.pwc.com/jp/en/taxnews-private-equity/assets/privateequity2011.pdf

2 For Korean PEFs established on or after 4 February 2009 that elect to apply the Korean tax partnership regime, at the time of allocation of the underlying income at the Korean PEF's fiscal year end.

is tax exempt in the country in which the LP is incorporated.

The above tax law amendment is effective for fiscal years commencing on or after 1 January 2013.

It is worthwhile noting that a foreign tax exempt LP which qualifies for the look-through treatment on the underlying income of the Korean PEF pursuant to the above rule should also qualify as a deemed beneficial owner for purposes of the new withholding tax rule effective from 1 July 2012. Under this rule, a non-resident beneficial owner wishing to claim a reduced treaty rate must submit an application form to the withholding agent. While the definition that deems qualifying pension funds and non-profit organisations as beneficial owners strictly applies only for claiming reduced treaty rates, the same treatment should arguably also apply in the context of treaty exemption claims.

Conclusion

While it remains to be seen whether the tax law amendment will have the intended effect of promoting the use of Korean PEFs by non-Korean private equity firms due to various restrictions and disclosure requirements that continue to apply in connection with using Korean PEFs, it may render Korean PEFs a more competitive structuring option, especially where the majority of the investors or cornerstone investors are foreign tax exempts.

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Australia
Tax treatment of gains derived by foreign private equity investors

On 11 November 2009, the Australian Commissioner of Taxation (**Commissioner**) sought to prevent the distribution of proceeds from an initial public offering of Myer Holdings Limited to its non-resident private equity (**PE**) investor, based on an assertion that Australian tax was payable on the profits.

In response to the debate over the appropriate tax treatment of gains derived by a foreign PE investor from an Australian investment, the Australian Taxation Office (**ATO**) released four Taxation Determinations (**TD**):

- TD 2010/20 – Confirming the ATO's view that it would apply Australia's general anti-avoidance rules where a company, resident in a treaty country, was interposed between the PE investor and the Australian investment without any commercial reasoning;
- TD 2010/21 – Outlining the Commissioner's view that the profit from the disposal of shares in a company acquired by a foreign PE investor was ordinary income, rather than a capital gain;
- TD 2011/24 – Finalising the Commissioner's view that the source of a gain derived by a foreign PE investor from the sale of shares in an Australian company is not solely dependent on where the sale and purchase agreement are signed. Instead, it requires all of the facts and circumstances to be considered; and
- TD 2011/25 – Confirming that it is possible to look through a foreign limited partnership to the limited partners in applying a relevant double tax agreement concluded between Australia and the country of residence of the limited partner.

A TD is a public ruling and an outline of the Commissioner's views on how Australia's tax laws apply, or would apply, to a specific set of circumstances. The ATO has not published any further guidance subsequent to the release of these TDs. However, the lack of any public rulings since 2011 is not an indication that the ATO is no longer focussed on foreign PE investments in Australia.

We are aware that the ATO has conducted approximately 100 detailed risk reviews of foreign PE funds holding investments in Australia, with more to come. These risk reviews are designed to collect information about the specific investments to understand the Australian tax outcomes (prior to an exit), including:

- Details of the funds and how they have been formed, including the identity of the fund manager and the residence of the limited partners;
- The circumstances surrounding the initial investment, such as how the opportunity was identified and where the negotiations and contracts were entered into;
- The acquisition structure and the

commercial reasons for implementing the chosen structure;

- How the business of the Australian portfolio companies are run and the level of involvement of the fund managers; and
- The fund's future exit strategies for the Australian investment.

These risk reviews also request details of other non-Australian investments held by the foreign PE funds.

In addition to the risk reviews, the ATO is also encouraging foreign PE funds to comply voluntarily with their Australian tax obligations and are encouraging these PE funds to engage with the ATO where they are contemplating the disposal of their Australian investment. Care needs to be taken as the ATO is strictly applying the principles in the TDs including the structure example used in TD 2010/20 and if your structure differs, the ATO may seek to initially argue Australia's general anti-avoidance rules apply.

Given the level of scrutiny that the ATO is placing on Australian investments by foreign PE funds, it is more important than ever that acquisition structures and exit strategies are put in place at the time of the initial acquisition that provide a high degree of certainty for the investors in the PE funds.

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Hong Kong
Extension of safe harbour rule to private equity funds

In a bid to promote the financial services industry, and develop Hong Kong's strength as a premier regional and international asset management centre and the leading offshore RMB centre, the Hong Kong Financial Secretary announced a series of measures in his 2013/14 budget speech on 27 February 2013, particularly targeted at the asset management industry. Of note, the extension of the profits tax exemption for offshore funds under the **Safe Harbour Rule**[1] to private equity funds is definitely a small step in the right direction, and should be warmly welcomed by the industry.

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The profits tax exemption for offshore funds under the Safe Harbour Rule is applicable to a non-resident fund, which has its central management and control outside Hong Kong with a Hong Kong fund manager. Transactions in private companies, however, are not included in the specified transactions in the prevailing Safe Harbour Rule. Hence, up to now, it is common for the Hong Kong asset management company of private equity funds to only take on research and advisory roles, rather than discretionary management functions, so as to mitigate the private equity funds' exposure to Hong Kong profits tax.

To enable private equity funds to operate on the same footing as other offshore funds, the private equity industry has been actively engaged in dialogue with the Hong Kong government to introduce measures that offer tax exemption certainty and foster the development of the private equity industry in Hong Kong.

In response, the Hong Kong government has proposed to extend the profits tax exemption for offshore funds under the Safe Harbour Rule to include transactions in private companies which are incorporated or registered outside Hong Kong and do not hold any Hong Kong properties nor carry out any business in Hong Kong. This initiative will allow private equity funds to enjoy the same tax benefits as other offshore funds and encourage more private equity funds to be managed in Hong Kong.

Details of the proposed relaxation of the profits tax exemption for offshore funds under the Safe Harbour Rule are anticipated to be announced soon. Private equity fund houses should start to position for the change, such as applying for a licence from the Hong Kong Securities and Futures Commission as it is one of the conditions for the tax exemption under the current Safe Harbour Rule.

The importance of private equity to the asset management industry in Hong Kong should not be underestimated. We will engage in continuous dialogue with the Hong Kong government to assist in the introduction of measures that will further develop the Hong Kong asset management industry. One of the measures is to consider extending the profits tax exemption for offshore funds under the Safe Harbour Rule to include investments via a Hong Kong platform, held by bona fide private equity funds with bona fide offshore investors. This will allow private equity funds, which often invest into China through a Hong Kong platform, to enjoy the Hong Kong profits tax exemption as well.

1 The Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006 pursuant to Section 20AC of the Inland Revenue Ordinance.

US taxation of non-resident capital gains

The United States generally has an attractive capital gains tax regime for non-US investors. While the US taxes its citizens and resident aliens on their worldwide taxable income, generally nonresident aliens and foreign corporations are taxed in the US only on income which is considered to have a US source and income that is effectively connected with a US trade or business.

US tax residence

In order to determine the income that will be subject to US federal income tax, first it must be determined whether an individual or entity is a US tax resident or rather considered a nonresident alien or a foreign corporation.[1,2]

An individual is a nonresident alien if he is neither a citizen of the US nor a resident of the US.[3] Generally, an individual will be treated as a resident of the US if he is a lawful permanent resident of the US (also known as the "green card test") or meets the substantial presence test.[4] Generally, an individual will be considered to have a substantial presence in the US during a calendar year if he was in the US for at least 31 days in the current calendar year and 183 days (based on weighted sum) in the current year and the two preceding calendar years.[5]

It should be noted that there are exceptions under which certain individuals are not considered US resident aliens despite meeting the substantial presence test (e.g., diplomats, temporary teachers, students).[6] Additionally, there are instances in which one may elect to be a US resident alien for all or part of a year despite failing the substantial presence test.[7]

A domestic corporation is one which is created or organised under the law of the US or of any of its states.[8] A foreign corporation is one that is not domestic.[9] Thus, an entity incorporated under the laws of a foreign country or US possession is a foreign corporation regardless of whether the management and control of the corporation is in the US.

1 This article will refer to nonresident aliens and foreign corporations as **"foreign persons"**.
2 The discussion below does not include consideration of the residence rules determined under an applicable US income tax treaty. US income tax treaties provide "tie-breaker" rules in order to determine the tax residence of persons who are considered a resident of both the US and the other treaty country under domestic rules.
3 Internal Revenue Code (**IRC**) section 7701(b)(1)(B).
4 IRC section 7701(b)(1)(A).
5 IRC section 7701(b)(3)(A). Under the weighted sum, each day in the US in the current year counts as one day; each day in the US of the prior year counts as 1/3rd of a day; and each day in the US in the second preceding year counts as 1/6th of a day.
6 IRC sections 7701(b)(3)(D) and 7701(b)(5).
7 IRC sections 7701(b)(4), 6013(g), and 6013(h).
8 IRC section 7701(a)(4).
9 IRC section 7701(a)(5).

Capital gains taxation of non-residents

Foreign source income derived by foreign persons is generally not subject to US taxation. Under US sourcing provisions, capital gains derived by a foreign person from the sale of non-depreciable personal property (e.g., securities not held as inventory) generally are considered foreign source income.[10] However, there are three notable exceptions under which gain that would otherwise be considered foreign source is considered from sources within the US. First, any capital gains transaction that is effectively connected with the conduct of a US trade or business is taxable as business income.[11] Second, capital gains derived from the sale of US real property or the stock of certain US real property holding corporations (**USRPHC**) is treated as effectively connected income (**ECI**)[12] and thus subject to US tax. An additional scenario in which a nonresident alien may be subject to US taxation on capital gains is where the nonresident alien is present in the US for at least 183 days during a taxable year.[13]

US trade or business and effectively connected income

Generally, income of a foreign person that is effectively connected with a US trade or business is subject to US taxation at regular individual or corporate income tax rates.[14] The first consideration is whether a foreign person has a US trade or business. The term "trade or business" in the US is not defined in the Internal Revenue Code or Treasury Regulations, but is a facts and circumstances test which has developed through case law and administrative guidance from the Internal Revenue Service (**IRS**). In general, the definition of US trade or business requires a lower threshold of activity than the income tax treaty standard of permanent establishment. Given the factual determination of the matter, the IRS has indicated that it will not issue private letter rulings on whether a foreign person is engaged in a US trade or business.[15] Generally, the activities must be considerable, continuous, and regular.[16] Though a single occurrence of activity can rise to the level of a trade or business[17], occasional, isolated or incidental activities generally do not.[18] The activity of the business must be active (e.g., not passive receipt of rental income) and conducted in the US.[19] Generally, activities of an independent agent are not imputed to a foreign person while the activities of a dependent agent are.[20]

The IRC does provide certain instances in which a foreign person will not be considered engaged in a US trade or business, most notably the trading safe

10 IRC section 865(a)(2).
11 IRC section 871(b).
12 IRC section 897(a)(1)(A).
13 IRC section 871(a)(2). While usually a person present in the US for 183 days or more during a taxable year will be considered a resident alien, there are instances in which an individual may be classified as a nonresident (e.g., diplomat, student, teacher, etc.) with a presence of 183 days or more in the US. The income must be US source income in order for the provision to apply.
14 IRC section 871(b) and 882(a).
15 See Rev. Proc. 2013-7, 2013-1 I.R.B. 233.
16 See, e.g., Pinchot v. Comm'r, 113 F.2d 718 (2d. Cir. 1940).
17 See, e.g., Rev. Rul. 58-63, 1958-1 C.B. 624.
18 See, e.g., Continental Trading, Inc. v. Comm'r, 265 F.2d 40 (9th Cir. 1959); Comm'r v. Piedras Negras Broadcasting Co., 43 B.T.A. 297 (1941), aff'd, 127 F.2d 260 (5th Cir. 1942); Linen Thread Co. v. Comm'r, 1941 W.L. 10375 (B.T.A. 1941).
19 See, e.g., Rev. Rul. 73-522, 1973-2 C.B. 226; Comm'r v. Spermacet Whaling & Shipping Co., 30 T.C. 618 (1958), aff'd, 281 F.2d 646 (6th Cir. 1960); Scottish American Investment Co. v. Comm'r, 12 T.C. 49 (1949).
20 See Rev. Rul. 70-424, 1970-2 C.B. 150; Hanfield v. Comm'r, 23 T.C. 633 (1955); Lewenhaupt v. Comm'r, 20 T.C. 151 (1953), aff'd, 221 F.2d 227 (9th Cir. 1955).

harbor. Trade or business within the US does not include (i) trading in stocks, securities, or commodities through a resident broker, commission agent, or other independent agent or (ii) trading in stocks, securities, or commodities on one's own account, whether by oneself or one's employees or through a resident broker or agent and whether or not any such employee or agent has discretionary authority to make decisions in effecting the transactions.[21] However, this exception does not apply to dealers in stocks, securities, or commodities and does not apply if the foreign person has an office or other fixed place of business in the US through which the transactions are effected.[22]

US real property interests

Gains derived by foreign persons from US real property interests (**USRPI**) are considered ECI and thus subject to US taxation. USRPI include an interest in real property located in the US or the US Virgin Islands and any interest, other than as a creditor, in a US domestic corporation unless the taxpayer can establish that such corporation was at no time a USRPHC during the shorter of the taxpayer's holding period or the five-year period ending on the date of the disposition of the interest.[23] If on the date of disposition, the corporation did not hold any USRPI, and all the interests held at any time during the shorter of the applicable periods were disposed of in transactions in which the full amount of any gain was recognised, then an interest in the corporation is not a USRPI.[24] In general, a corporation is a USRPHC if the fair market value of the USRPI held by the corporation on any applicable date equals or exceeds 50% of the sum of the fair market values of its (1) USRPI, (2) interests in real property located outside the US, and (3) certain business assets.[25] Gain from the disposition of stock of a publicly-traded corporation will be treated as a USRPI only where the company issuing the equity is a USRPHC and the person disposing of the interest held more than 5% of the shares at any time within the last five years.[26] Accordingly, if a foreign person invests in listed US securities and has not owned more than 5% of the shares within the last five years, there is no need to determine whether the US company is a USRPHC and that foreign person should not be subject to US federal taxation on the gains derived from the sale of those listed shares.

Summary

Capital gains derived on the sale of US stock or securities by a non-resident should generally not be subject to US income tax. Generally capital gains would be subject to US income tax in situations where the gain is attributable to a US trade or business or permanent establishment of the non-resident in the US, if the gain relates to an interest in a USRPI, or if the gain relates to an interest in a partnership engaged in a US trade or business or holding a USRPI. Investors should consult with their tax advisors before investing in US assets.

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21 IRC sections 864(b)(2)(A) and 864(b)(2)(B).
22 IRC section 864(b)(2).
23 IRC section 897(c)(1)(A).
24 IRC section 897(c)(1)(B).
25 IRC section 897(c)(2).
26 IRC section 897(c)(3).

Transfer pricing for carried interest

In 2012, PwC published *Clarifying the rules: Sustainable transfer pricing in the financial services sector.* In the chapter on transfer pricing for private equity, that text states:

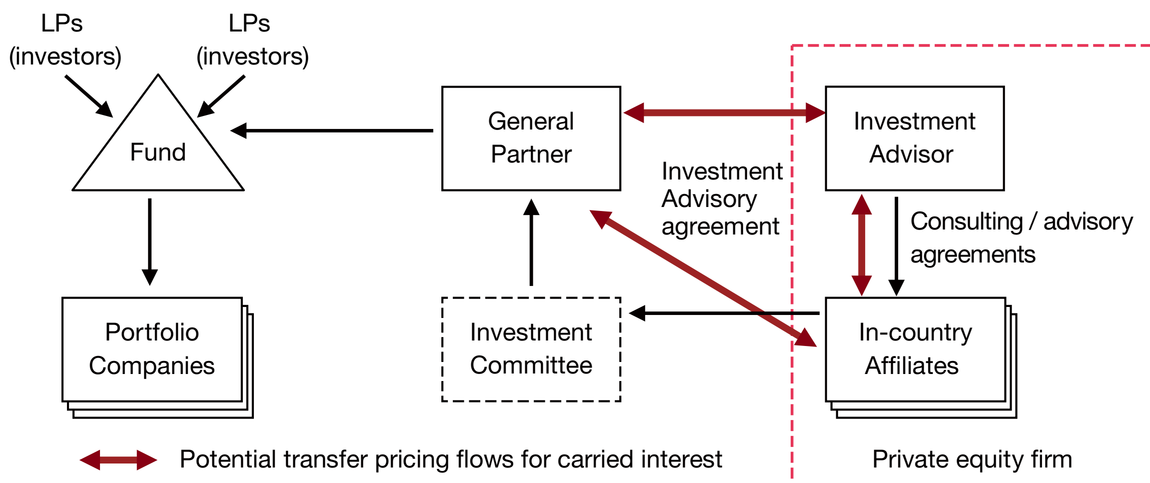
"...it may not be clear whether any carried interest earned should be classified as part of the revenues of the private equity firm, or whether it is in fact a return on equity (which is outside the scope of transfer pricing)."[1]

Since then however, there has been an increased focus on the appropriate tax treatment of carried interest, particularly by US lawmakers, i.e., whether carried interest should continue to be taxed as capital gain or should instead be taxed as ordinary income. As this discussion expands globally, it is likely to raise the profile of carried interest in the minds of tax authorities worldwide and therefore to increase the likelihood of questions being asked about the treatment of carried interest upon audit – not only for individuals but also for affiliates within private equity firms. The question may arise for instance, as to whether in-country affiliates, which are often remunerated on a cost plus basis, should now also earn some share of carried interest.

Given this background, and particularly if the US rules are changed to treat carried interest as ordinary income for individual tax purposes, we anticipate that an increasing number of private equity firms will review the question of allocation of carried interest within their group structure and the transfer pricing ramifications that may result. Figure 1 below demonstrates the three potential situations in which a transfer pricing arrangement relating to carried interest might arise in the context of a private equity firm, i.e., between the general partner (**GP**) and the lead investment advisor; between the lead investment advisor and one or more of its in-country affiliates; or between the GP and those affiliates directly.

This article outlines one potential transfer pricing analysis that may be helpful in determining how carried interest should be shared between the entities within a private equity firm.

Figure 1 Potential transfer pricing arrangements for carried interest



1 Section 5.7.3, Carried Interest, pages 60-61. http://www.pwc.com/gx/en/tax/assets/pwc-clarifying-the-rules.pdf

Selection of transfer pricing method

The difficulty with transfer pricing analyses of carried interest is that it is highly unlikely there will be any comparable market data by which any of the traditional transactional transfer pricing methods will be able to be applied.[2] In addition, it is also unlikely the tax authorities in most countries will accept a transactional net margin method be applied to the entity in their jurisdiction – particularly if the carried interest is significant. Consequently, the fallback transfer pricing position for carried interest will often (although not always) be some form of revenue or profit split.

Whether the split methodology is revenue based or profit based will depend on a number of factors, including the availability of data, any other transfer pricing flows within the private equity group, and the legislative requirements in the relevant jurisdictions. As a general rule and due to ease of implementation, these splits are more likely to be carried out based on revenue (i.e., the amount of carried interest) rather than based on profit (i.e., the amount of carried interest less costs of the entities entitled to share in the carried interest). For convenience in the remainder of this article however, we shall refer to both types of split as a "profit split".

Profit split approaches

Although the specific details will differ from jurisdiction to jurisdiction, the objective of a profit split is to determine the arm's length allocation of the profit earned from a transaction between the parties to that transaction. In the absence of comparable data as to how third parties would have split the profit (which is almost certain to be the case for carried interest):

"…it is often based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions…"[3]

While asset-based or cost-based allocation keys are generally preferred to assess the relative value of the functions performed in a profit split analysis, this may be difficult to apply in the private equity world. On the asset side, it may be difficult to identify any specific assets used, as profits are generally driven by the skill and expertise of the private equity firm's personnel rather than by investment in tangible or intangible assets. Likewise, it may also be difficult to define the appropriate cost base to be used where the parties to the transaction are engaged in providing other services, such that a segmentation of costs is required, or where the costs incurred by an entity (e.g., the GP) do not truly represent the value contributed to the transaction by the roles and responsibilities of that entity.

In these more difficult cases, which are commonly found when considering carried interest, it may be necessary to split the profit based on a qualitative evaluation of the relative contribution of the functions performed, assets owned and risks assumed by each party to the transaction. However, this *"evaluation should be supported by reliable objective data in order to limit arbitrariness."*[4]

The remainder of this article describes one such qualitative or "functional" contribution analysis that has been designed so as to eliminate as much arbitrariness

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2 Comparable uncontrolled price method, resale price method or cost plus method.

3 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (**OECD Guidelines**), ¶2.119.

4 OECD Guidelines, ¶2.144.

as possible. Given the lack of comparable data and the inability to easily apply asset-based or cost-based profit splits to carried interest, this model may be of benefit to private equity firms considering transfer pricing in this area.

Functional contribution analysis

The proposed functional contribution analysis has four key steps:

1. List all of the tasks performed by all entities in the private equity group in the entire transaction value chain. For each task, identify the entity performing and classify as routine or non-routine. This should be a fact based analysis and should be consistent with any agreements entered into between the relevant entities or third parties and with internal guidelines and policy documents. Thus, it should leave little room for arbitrariness.

2. The tasks identified at Step 1 should be grouped by function, such as capital raising, deal origination, investment, monitoring, divestment, etc. Each function should then be given a percentage weighting relative to all other functions. The assessment of relative weightings should be made by all key personnel involved in the business (both at the GP level and on the advisor side), in order to avoid any single viewpoint influencing the overall analysis.

3. In the same manner, a weighting should be given to routine and non-routine functions. In this case, however, the weightings can generally be based on either internal or external comparable data to ensure objectivity.

4. Finally, the relative contribution of each entity to the transaction can be calculated based on the tasks each has performed weighted by function and by classification as routine or non-routine.

The result derived from the above steps should be an allocation of carried interest between all relevant entities that is as objective as possible, and thus that minimises the room for challenge by the tax authorities.

Conclusion

While many private equity firms may still be considering whether carried interest should be treated as revenue or as a return on investment, it is likely that over time tax authorities in many jurisdictions will push to have carried interest dealt with as ordinary income for individuals. Thus, questions about transfer pricing for carried interest are likely to increase, as this treatment is built into the transfer pricing allocation of revenue between the affiliates of the private equity firm.

This article has provided a high-level overview of one potential approach to allocating carried interest between entities of a private equity group, where there is no comparable data from which an arm's length allocation may be drawn, and where there is no asset-based or cost-based internal data by which the relative contribution of the entities to the transaction can be measured.

This approach is described as a functional contribution analysis, and is designed to evaluate the relative contributions of the parties to the transaction based on the functions, assets and risks of each of them, minimizing the risk of arbitrary allocations.

Through this process, the taxpayer should be able to demonstrate to the tax authorities that it has established arm's length pricing in an area that has historically been the subject of some uncertainty.

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Trade compliance – an underestimated area?

Background – customs and international trade risks

When deriving findings on potential exposures, risk assessment and recommendations, customs and international trade topics are more often than not excluded from a typical due diligence analysis. However, many companies may well have some involvement in import and/or export activities, even if they do not realise it. For example, banks and trading houses may take flash title to products when they move across borders, thus becoming liable for duties and subject to import or export licensing requirements. Customs law typically defines responsibility for trade compliance quite broadly, including not only parties that have title to or possession of goods that cross a border, but also often any party with a beneficial economic interest.

Hence the relevance of questions relating to customs procedures, trade barriers, import licenses, trade embargoes, as well as compliance with more narrow customs duty aspects of a target acquisition should not be underestimated.

Assessing trade compliance risks - going beyond the "typical" due diligence

As mentioned, a "typical" due diligence scope does generally not include customs and international trade topics. International trade risks are both tax and operations related, and therefore span both tax and operational due diligences. Often, they fall in the gap between the two. There are a large number of undisclosed risks, hidden liabilities or onerous commitments that are 'under the radar'.

If a target is engaged in the international trade of goods or services, at a minimum, a quick assessment of likely risks is in order. An appropriate due diligence should scope issues as accurately as possible and tailor them to the industry and country the target company is operating in. Focus areas can vary widely from industry to industry. For example, usage of free trade agreements (**FTAs**) may be a focus area for the automotive industry in the Asia region, whereas pharmaceutical companies may be more concerned about import licensing and companies dealing with high-tech products with export control regulations.

A summary of the main issues to be addressed in connection with customs and international trade risks frequently includes the following:

- **Compliance with formal customs procedures**

  Regardless of the country in which a company operates, the formal aspect of customs procedures are generally very strict, especially when special duty relief schemes are applied. Even where no customs duties are levied, specific procedures need to be fulfilled and the necessary approvals need to be obtained from local customs authorities.

  Customs regulations in most countries provide for a range of trade fa-

cilitation schemes such as inward and outward processing relief, processing under customs control, temporary admission, free trade zones, bonded zones, etc. Often, by granting advantages such as duty suspensions, Customs will give up revenue and thus require the importer to meet strict conditions and adhere to strict rules and procedures. If a company does not comply with the formal conditions established under a specific customs scheme, the consequences can be very harsh, including back-pay of the duty relief granted and in some circumstances penalties as well.

In particular, customs schemes applied for should be identified and taken note that all requirements were still complied with.

- **Declarations under FTAs**

  Under an applicable FTA, imports may benefit from preferential duty treatment, subject to conditions, such as being qualified under the rules of origin. Where such conditions are not met, preferential treatment may be denied retrospectively, potentially resulting in significant additional customs duties and penalties.

  The manner in which preferential origin calculations are made should be investigated by analysing underlying documentation and reconstructing origin calculations. If anything seems amiss, questions could be raised during management interviews and any potential issues may so be properly flagged and evaluated.

- **Dual- use export controls**

  Export controls over so-called 'dual-use' goods carry perhaps the greatest risk from a customs and trade perspective. The failure to obtain required licenses has resulted in companies receiving fines in the tens of millions of dollars in some countries as well as individuals facing criminal proceedings. In addition, companies have been stopped from exporting any products from a particular country for a period of time. It is often not obvious what types of products may be considered 'dual use' and fall under the regulations.

  In order to identify potential export controls noncompliance, whether exported products meet the specifications of 'dual-use' goods and whether necessary export licenses have been obtained where applicable should be reviewed.

On the more positive side, in addition to identifying the above risks and potential issues, a customs and international trade due diligence may also lead to identifying opportunities, maintaining reputation and having the ability to trade goods worldwide without running regularly into regulatory challenges.

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Japan
Sun in waiting

The ray, coming from private equity investors, has never left Japan's economic skies. Long-term equity investors' unwavering faith of Asia's largest developed economy was most conspicuous in the period after the March 11 natural disasters. Instead of a decline of private equity activities, the records for both 2011 and 2012 have been encouraging. In fact, they overshadowed those for 2009 and 2010, the years immediately after the fall of Lehman Brothers.

By all accounts, the world's third largest economy, Japan, showed no signs of being humbled by the earthquake and the tsunami that subsequently followed. If private equity activities taking place in the months and the year after the natural disasters can be used as a yardstick to measure long-term equity investors' assessment of Japan, then a bright new dawn is awaiting this asset class in the country.

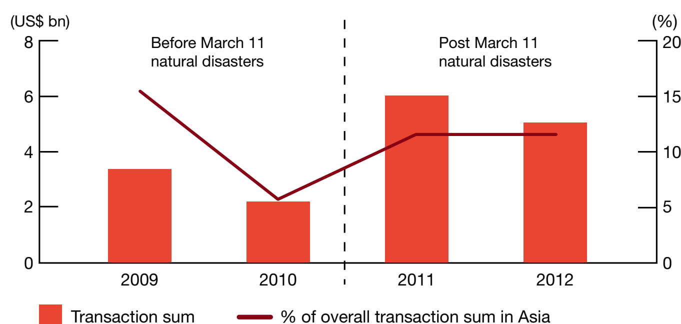
Believers abroad

Private equity investors, in particular those based outside of Japan, displayed their unwavering commitments to Japan. Months after the March 11 natural disasters, Bain Capital LLC took control of Skylark Co., Ltd. for ¥160 billion (US$2.1 billion). The transaction is not only the largest in Japan since 2008, but remains as the largest in the secondary segment. In the following year, the UK-based Permira took over Akindo Sushiro Co., Ltd. for an enterprise value of US$1 billion.

In the 24 months ending December 2012, Japan welcomed an aggregate US$11.2 billion in transaction sum committed by private equity investors, virtually double the US$5.6 billion recorded for the preceding two years (Figure 1). Reflecting foreign investors' staunch belief in their ability to enhance the value of Japan-based assets, even though the country has long suffered economic doldrums, deals at US$1 billion and above were all consummated by non-domestic firms (Figure 2).

Although domestic investors have shied away from billion-dollar deals, they maintained their share of capital deployment. In both 2009 and 2010, Japan's home-grown private equity firms accounted for around 35% of the US$5.6 billion in transaction aggregate. The March 11 natural disasters did not dent their commitment to funding promising companies. In fact, the percentage edged up by a notch during the two years ending 2012 (Figure 3).

Figure 1 Investment pace (2009 - 2012)



	2009	2010	2011	2012
Transaction sum (US$bn)	3.4	2.2	6.1	5.1

Private equity investors were not deterred by the March 11 natural disasters -

- Jan/2011-Dec/2012: US$11.2 billion in transaction aggregate, whereas
- Jan/2009-Dec/2010: US$5.6 billion in transaction aggregate

Source: ASIA PRIVATE EQUITY REVIEW

Figure 2 Largest deals completed (2009 - 2012)

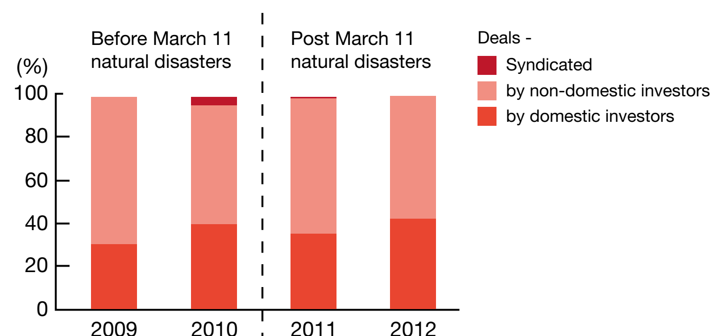
Year	Company	Investor(s) (headquarters)	Deal size
2011	Skylark Co., Ltd.	Bain Capital LLC (USA), HarbourVest Partners (USA)	2.2
2012	Jupiter Shop Channel Co., Ltd.	Bain Capital LLC (USA)	1.3[(1)]
2009	Bellsystem24 Inc.	Bain Capital LLC (USA)	1.1
2012	Akindo Sushiro Co., Ltd.	Permira (UK)	1.0
2011	Tsubaki Nakashima Co., Ltd.	The Carlyle Group (USA)	0.8

All amounts in US$bn
(1) Estimated

Foreign private equity firms displayed no signs of recoiling back from Japan. Of the five largest deals undertaken between 2009 and 2012, all were consummated by foreign firms.

Source: ASIA PRIVATE EQUITY REVIEW

Figure 3 Deal participations by domestic & non-domestic firms (2009 - 2012) – by amount



Deals -
- Syndicated
- by non-domestic investors
- by domestic investors

	2009	2010	2011	2012
Syndicated	0%	4%	1%	0%
By non-domestic investors	70%	56%	64%	58%
By domestic investors	30%	40%	35%	42%

Domestic investors have maintained their share of capital deployment –

- Jan/2011-Dec/2012: accounted for 38% of the US$11.2 billion in transaction aggregate
- Jan/2009-Dec/2010: accounted for around 35% of the US$5.6 billion in transaction aggregate

Source: ASIA PRIVATE EQUITY REVIEW

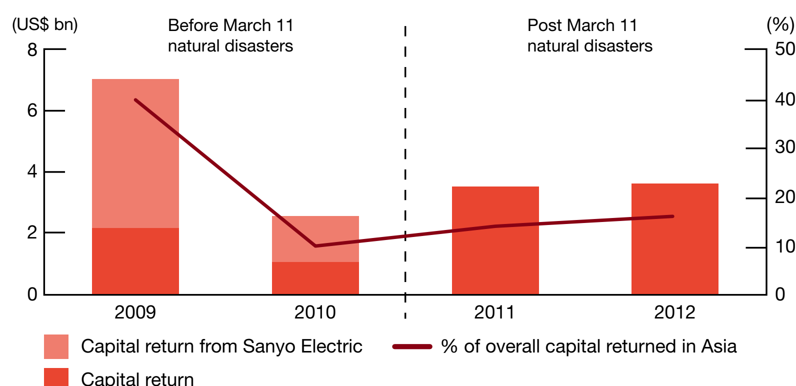
Capital return increase

The earthquake that shook under Japan on March 11 did not give way to fissures that swallowed up private equity returns. The US$3.6 billion that was returned to private equity investors by Japan-based companies in 2011 was a 40% increase compared to that for 2010. In the two years ending December 2012, over US$7.3 billion has been returned to investors (Figure 4).

There are elating reasons for faithful investors of Japan to ridicule its sceptics. In the year when the country was afflicted by its worst natural disasters in recent history, the overall median return multiple for assets being sold was 1.5 times the invested capital; exceeding that for the preceding year by 20 basis points. In 2012, the median return multiple has increased to 1.7 times (Figure 5).

Ironically, it is also in the period after the March 11 natural disasters that Japan's private equity market boasted some of its most outstanding divestment results. In 2012, Unison Capital concluded its 5-year long investment in Akindo Sushiro Co., Ltd. and achieved an exit multiple of more than 7.6 times after committing a total of around US$100 million to the sushi restaurant chain operator. In the same year, Cerberus Capital Management LP decided to begin to close its account with Aozora Bank Ltd. After rounds of share disposals, the US-based investment firm clocked a return multiple of more than 2.4 times, on a realised and unrealised basis, from an estimated invested capital of US$1.5 billion (Figure 6).

Figure 4 Capital return pace (2009 - 2012)

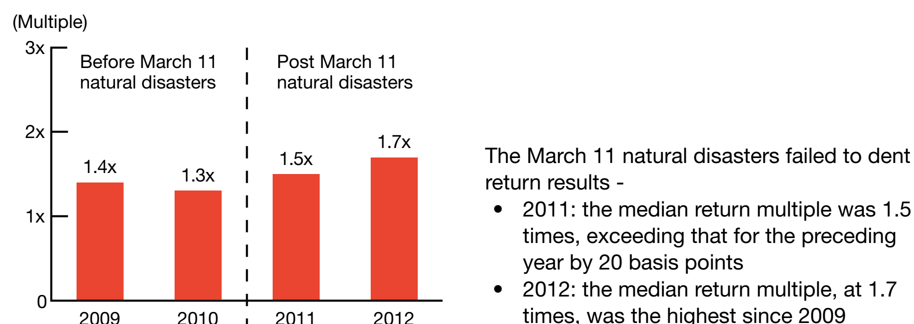


	2009	2010	2011	2012
Capital return from Sanyo Electric (US$bn)	5.0	1.6	-	-
Capital Return (US$bn)	2.2	1.0	3.6	3.7

- The 2009 and 2010 return results have been skewed by a total of US$6.6 billion returned in the sale of Sanyo Electric Co., Ltd.
- If the capital returned from Sanyo Electric Co., Ltd. is removed, the return results in 2011 and 2012 affirm private equity investors' ability to achieve liquidity for their Japan portfolio companies after the March 11 natural disasters

Source: ASIA PE INDEX

Figure 5 Return results – by median exit multiples (2009 - 2012)



The March 11 natural disasters failed to dent return results -

- 2011: the median return multiple was 1.5 times, exceeding that for the preceding year by 20 basis points
- 2012: the median return multiple, at 1.7 times, was the highest since 2009

Source: ASIA PE INDEX

Figure 6 Return results in selected exits (2009 - 2012)

Year	Company	Investor(s)	Amount Returned	Gross Multiple
2012	Akindo Sushiro Co., Ltd.	Unison Capital	820	7.6x
2012	Aozora Bank Ltd.	Cerberus Capital Management LP	384	3.7x
2011	Vantec Corp.	Mizuho Capital Partners	273	5.0x(1)
2010	Q'Sai Co., Ltd.	Daiwa Corporate Investment Co., Ltd., Japan Industrial Partners, Inc, Polaris Capital Group Co., Ltd.	413	2.8x
2009	Nikko Asset Management Co., Ltd.	GIC Special Investments Pte. Ltd., Nikko Principal Investments Japan, Warburg Pincus	435	3.8x

All amounts in US$m
(1) Estimated to be over 5x

Source: ASIA PE INDEX

Pragmatism reigns

Japan's institutional investors are increasingly asserting themselves on the global finance stage and taking a much more pragmatic approach in their capital deployment; and 2012 was a pivotal year.

During 2012, Government Pension Investment Fund (**GPIF**) began to take its first step into the alternative asset space. It is currently reviewing real estate, infrastructure and private equity as potentially other viable asset classes for its allocations.

At the same time, four of Japan's leading institutions have taken bold steps into the global infrastructure space. Japan Bank for International Cooperation teamed up with Mitsubishi Corp., Mizuho Financial Group, Inc. and Pension Fund Association and announced their joint US$2.5 billion commitment to the US$7.5 billion initial closing of Global Strategic Investment Alliance which has a final target of US$20 billion.

It was however Orix Corp.'s decision to take over the Netherlands-based Robeco Groep N.V., for €1.9 billion (US$2.6 billion) that was by far the most emphatic statement by corporate Japan that it is ready to broaden its horizon into the private equity investment arena (Figure 7).

Observation

After a period of lull, private equity in Japan has stealthily been making a comeback. This, coupled with surging interest displayed by the country's domestic financial institutions and corporate investors to enter the private equity arena, is a powerful combination. It shall be a glary private equity sky in Japan when GPIF, the world's largest asset management firm with ¥107.7 trillion (US$1.4 trillion) under management, decides to make allocations to private equity.

Figure 7 Institutions venturing abroad into alternative space

Date	Institution names	Amount committed	Investee	Investment scope
Feb 13	ORIX Corp.	2.6	Robeco Groep N.V.	Global
Feb 09	Japan Bank for International Cooperation	2.0	IFC Capitalization Fund	Global
Apr 12	Pension Fund Association	1.25	Global Strategic Investment Alliance	Global
Apr 12	Japan Bank for International Cooperation, Mitsubishi Co., Mizuho Corporate Bank, Ltd.	1.25	Global Strategic Investment Alliance	Global

All amounts in US$bn

Source: ASIA PRIVATE EQUITY REVIEW

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