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Asia-Pacific Investment Fund Tax Structures

by Stephen Banfield, Mark Gao, Peter Ni, Manuel Makas, Eric N. Roose, and Jay Shim

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In this article, the authors focus on Singapore investment funds and how Asian-Pacific funds established in Singapore, or the traditional Cayman fund, structure their investments into Australia, China, Japan, and South Korea.

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Most Asian-Pacific investment funds are established in the Cayman Islands in the form of a limited partnership; unit trust; or less common, a corporation, managed offshore under the Cayman Islands regulatory regime that is easy for investment managers to comply with. Those fund structures have existed for a long time and most investors consider them market-standard fund structures.

Those kinds of Cayman funds are sometimes structured to claim tax treaty benefits, thereby reducing the fund's effective tax rates for investments into high-tax jurisdictions in the Asia-Pacific region, such as Australia, China, India, Japan, and South Korea. Numerous Asian jurisdictions, such as China, India, Indonesia, and South Korea have adopted strong general antiabuse tax legislation and anti-treaty-shopping and indirect transfer rules, designed to impose taxation on foreign funds that claim tax treaty benefits or engage in tax-efficient exit strategies. Investment jurisdiction tax authorities use those rules to challenge structures; notable examples include India and South Korea, which have aggressively challenged treaty benefits claimed by Cayman funds, and China, which has often asserted its right to tax sales of offshore holding companies by Cayman funds under its indirect transfer tax rules.

In addition to domestic tax legislation like that, the OECD's base erosion and profit-shifting project and multilateral instrument have challenged conventional offshore structures that are primarily tax driven. Action 7 requires nations that sign on to the MLI to elect which test must be satisfied by taxpayers claiming treaty benefits. For example, Japan and Singapore, both signatories to the MLI, have adopted the principal purpose test, which requires the funds to have a nontax principal business purpose to support the claim for a treaty benefit.

In addition to those important tax considerations and developments, institutional and high-net-worth investors are increasingly hesitant to invest in Asian-Pacific funds established in the Cayman Islands, in large part because of the negative market perceptions created by leaked disclosures of confidential offshore company information, such as the Panama Papers.

Even before those negative media reports, European pension funds, financial institutions, and institutional investors adopted investment policies that precluded them from investing in funds established in offshore tax havens, making it impossible for them to invest in large investment funds targeting Asia using traditional Cayman entities. Those European investors usually can invest only in Asian-Pacific funds established in Luxembourg, which limits their ability to invest in the Asian-Pacific market. The practical ability for many Asian-based investment managers targeting the Asia-Pacific region to establish Luxembourg funds is limited (or in some cases impossible) because the investment management teams for those kinds of Asia-focused funds are generally based in Asia (usually Singapore and Hong Kong).

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In response to significant tax developments and negative public perceptions of offshore jurisdictions such as the Cayman Islands, fund tax advisers to Asian investment managers sponsoring Asian-Pacific funds are increasingly considering "onshore" domiciled funds. For investment funds with an Asia-Pacific mandate or with local investment management presence in Asia, a Singapore funds structure provides a compelling solution. Singapore has a highly attractive funds tax regime, an extensive tax treaty network, and an investment management regulatory regime administered by the Monetary Authority of Singapore (MAS), which is highly regarded by investors and considered equal to the regulatory authorities of respected funds jurisdictions, such as Luxembourg and the United States.

This article focuses on the forms of Singapore funds today (as well as the Singapore variable capital company, or VCC) and how Asian-Pacific funds established in Singapore, or the traditional Cayman fund, structure their investments into Australia, China, Japan, and South Korea.

Singapore Investment Funds

Singapore continues to gain prominence as a global funds center. According to a 2016 survey by the MAS, Singapore had reached SGD 2.7 trillion (approximately $2 trillion) of assets under management, an amount that grew to SGD 3.3 trillion by the end of 2017. Approximately 70 percent of assets under management are invested in the Asia-Pacific region, which shows that Singapore is a hub for the deployment of regional capital. Several factors have contributed to the success of Singapore as a preferred asset management hub, including geographic proximity to investors and investment opportunities, a pro-business environment, progressive and careful regulatory oversight, and a conducive tax regime.

Common Fund Structures

Singapore-based asset managers manage a range of offshore and domestic investment structures. Cayman limited partnerships will often pool into intermediate corporate sub-funds that include Singapore companies established on an asset-by-asset or collective basis. The economic substance associated with a local fund manager supports a claim by those entities that they are eligible for access to Singapore's expansive tax treaty network.

A growing trend is the replacement of offshore master pooling vehicles and feeder funds with onshore entities. That is in part a response to international tax policy initiatives such as BEPS and institutional investors' increasing aversion to structuring using tax haven jurisdictions.

It is possible to build an entirely onshore investment structure with the equivalent flexibility of tried and tested offshore structures using entities that may be established under Singapore law. The entity types are based on the common law trinity of companies, partnerships, and trusts, although the VCC has recently been added. That modular quality of Singapore fund structures is key to their appeal and flexibility. That is supported by the suite of local tax incentives that can be used to reduce Singaporean tax on repatriated investment flows and realization gains.

In addition to unlisted alternative funds with a regional mandate, real estate investment trusts and registered business trusts are popular listed vehicles for investments into mature real estate and infrastructure assets, respectively. Different investment structures are also available for investments in Singapore real estate.

The fund tax incentives described below do not exempt income and gains from Singapore real estate.

Variable Capital Company

The introduction of the VCC is intended to further enhance Singapore's appeal as an international fund management hub. It expands Singapore's toolbox of domestic vehicles and brings it into closer alignment with competitor jurisdictions such as Hong Kong, Ireland, Luxembourg, and traditional offshore locations. Enabling legislation was passed into law in October 2018 and is expected to become operative shortly.

The VCC has several key features. It must be a collective investment scheme as that term is defined by the Singapore Securities and Futures Act (Cap 289) (SFA). In response to industry feedback, the MAS scrapped an earlier proposal

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to require a minimum of two investors in a VCC. The MAS describes a VCC with multiple cells as an "umbrella VCC" and has confirmed that it is possible for an umbrella VCC to have both open- and closed-end funds as its sub-funds.

A VCC must appoint a fund manager that is licensed under the SFA; some exempt fund managers, including registered fund management companies, may also manage a VCC. Investors can directly invest in the VCC as members and hold shares that are transferable and redeemable. It can be expected that a transfer of a VCC's shares will be subject to Singapore stamp duty in the typical manner.

VCCs must appoint an auditor, but not an audit committee, to audit their accounts annually. Each sub-fund will be required to prepare separate financial statements, which must be audited and prepared in accordance with a single accounting standard across all sub-funds. A VCC, which is an authorized or restricted scheme under the SFA, must also appoint a custodian, subject to various conditions. The MAS has said VCCs used as private equity and venture capital fund vehicles are exempted from this requirement, which aligns with the position for those funds under the SFA.

A VCC will have variable capital that is fundamental in facilitating investment redemptions. It can register and segregate its assets into different sub-funds held within the same legal entity, and can then use each sub-fund to invest and directly hold a portfolio of different investments. The VCC Act includes several measures to avoid cross-cell contagion, so that liabilities against one sub-fund can be prevented from being claimed against another.

A VCC's member registry does not need to be made public.

A VCC can access the suite of tax incentives available under the Singapore Income Tax Act (Cap 134). It can also apply for a certificate of tax residency and is meant to be able to access benefits under Singapore's treaty network. Foreign corporate entities may also apply to be redomiciled in Singapore as a VCC. That concept is broadly consistent with redomiciliation provisions introduced into the local Companies Act in early 2017.

Taxing Funds Managed in Singapore

Singapore's corporate tax rate is 17 percent. The tax is semi-territorial and applies to income that is Singapore-sourced, or foreign-sourced and remitted into Singapore. That basis of taxation means the activities of a local fund management company could cause tax exposure for the entities it manages. That risk extends to realization gains, which could be characterized as revenue — particularly when made by a fund with a relatively short investment time horizon.

The ITA has several incentives to mitigate the risk of Singapore taxation at the fund level and the impediment that tax might otherwise represent for local industry development. Three are commonly relied on: the enhanced-tier fund incentive, the offshore fund incentive, and the Singapore resident fund scheme.

Enhanced-Tier Fund Incentive

A fund managed out of Singapore can apply for approval under the enhanced-tier fund scheme of ITA section 13X of the ITA; an approved fund is exempt from Singapore tax on "specified income" derived from "designated investments." Those are both defined terms that encompass a range of assets and associated income and gains. The main omissions from that exemption are income and gains from Singapore immovable property, distributions from Singapore real estate investment trusts, and limited types of Singapore-sourced interest income.

The section 13X incentive is available for the life of the fund, if the approval conditions are met and continue to be satisfied. MAS approval is discretionary, and the following minimum conditions must be met at the time of application:

- the fund is managed or advised by a Singapore fund manager, or a company that is either licensed or exempt from licensing for fund management under the SFA;
- the Singapore fund manager must employ three "investment professionals," defined as an individual who earns at least SGD 3,500 per month and is substantively engaged in fund management activities;
- the fund must have a minimum of assets under management of SGD 50 million, which may be satisfied on a committed capital basis for specific real estate, private equity, and infrastructure funds; and

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- the fund must incur local business spending of at least SGD 200,000 annually.

Domestic funds structured as VCCs may also benefit from the section 13X exemption if they satisfy those conditions.

Offshore Fund Incentive

An offshore fund that has appointed a Singapore fund manager can apply for approval under ITA section 13X, and it may alternatively rely on the offshore fund incentive of section 13CA, if applicable.

The requirements of the offshore fund incentive are built around the definition of a prescribed person. That can be a fund established as a company or trust, or it can also be an individual's managed account. Partnerships are treated as passthrough entities under this incentive, which means the relevant criteria are applied at the partner level. To be eligible for the incentive, the fund must not be resident in Singapore at any time during the financial year and cannot have a permanent establishment in Singapore other than that created by virtue of the appointment of a local fund manager.

A key part of the offshore fund incentive is a separate financial penalty regime, which claws back tax saved at the fund level when Singapore corporate investors hold more than a set percentage of the fund (30 percent if a fund has fewer than 10 owners, 50 percent if it has 10 or more).

Singapore Resident Fund Scheme

Section 13R of the ITA establishes the Singapore resident fund scheme, which is essentially the equivalent of the offshore fund incentive for Singapore incorporated and resident fund vehicles. The scope of the tax exemption is the same as that under sections 13X and 13CA. To qualify, the fund must:

- be a company incorporated and resident in Singapore;
- be managed by a Singapore fund manager;
- have annual business spending of more than SGD 200,000; and
- be administered by a Singapore-based fund administrator.

Penalties under the Singapore resident fund scheme are similar to those for offshore funds relying on section 13CA; they apply when a Singapore corporate investor holds more than 30 or 50 percent of a fund depending on the total number of investors.

Domestic funds structured as VCCs can also apply for approval under the section 13R scheme.

Taxation of Singapore Fund Managers

Fund managers are subject to Singapore tax at the standard rate of 17 percent. Income derived from carrying on fund management activities in Singapore is considered Singapore-sourced and therefore taxable as it arises.

Fund managers in Singapore must comply with the arm's-length principle in computing their management or advisory fees and when following new transfer pricing documentation requirements. Goods and services tax potentially applies at the rate of 7 percent on the services provided by a Singapore fund manager, although several modifications and concessions are relevant.

Financial Sector Incentive — Fund Management

A fund manager having at least three investment professionals and SGD 250 million under management may apply for the financial sector incentive-funds management scheme. The MAS may grant approval if a fund manager provides a business plan demonstrating growth in headcount, assets under management, and business spending.

Approval under the financial sector incentive-funds management scheme reduces to 10 percent the Singaporean tax on a fund manager's qualifying fee income. That includes fees paid by funds approved under the sections 13R or 13X schemes, or that satisfy the requirements of section 13CA.

Carried Interest

How to tax carried interest in Singapore is unsettled, and the ITA has no specific provisions providing legislative clarity or safe harbors. By its nature, carried interest is a benefit typically enjoyed by investment professionals in their personal capacity and is not paid through a fund management entity. The risk is that an individual's carried interest entitlement could be

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recharacterized as personal services income and subject to tax at higher rates.

Australia Investment Tax Structures

The managed investment trust (MIT) is the preferred vehicle for passive foreign investment into Australia because of the potential for a concessional 15 percent[1] tax rate on returns to foreign investors. The government is in the process of introducing integrity measures that limit when that concessional withholding tax rate applies. The following discussion assumes the integrity measures will be introduced in their proposed form.

Qualification Criteria for an MIT

The MIT is an Australian unit trust whose qualification criteria limit the circumstances in which foreign investors can benefit from the lower tax rate; the three key criteria are that an MIT has an Australian investment manager, is widely held, and makes only specific types of passive investments.

Australian Investment Management

For MIT investors to qualify for the lower tax rate, a substantial proportion of the investment management activities must be carried out in Australia, relative to specific trust assets. Relevant assets are those situated in Australia, listed on an Australian stock exchange, and taxable as Australian property (broadly, assets whose value is derived primarily from Australian real estate).

Activities constituting investment management include market analysis and identifying potential investments, due diligence of potential acquisitions, and providing recommendations on the asset mix of the trust — that is, buy and sell recommendations. In determining whether those activities are performed in Australia, a substance-over-form approach is applied. Under that approach, for example, appointing an Australian investment manager that subcontracts its role to a nonresident manager would not be acceptable; nor would appointing a nonresident manager that purports to make decisions in Australia on a fly-in, fly-out basis.

Importantly however, while the investment manager must be in Australia, the exercise of authority by a foreign unit holder to approve or decline the investment manager's recommendations from outside Australia should not result in failing that test. Further, the investment management test is applied annually, considering the services provided in each year of income. Therefore, if a nonresident entity is involved in the decision associated with the establishment of the trust, the trust can still become an MIT in subsequent years of income if the fund's ongoing management is assumed by an entity in Australia.

Accordingly, to use an MIT, a foreign investor must be prepared to have the investment management functions associated with the MIT occur in Australia, noting that limited foreign oversight is permitted.

Widely Held Ownership

To qualify as an MIT, a trust must meet minimum membership requirements. The number of members required varies based on whether the trust is considered retail or wholesale — retail trusts require at least 50 members, while wholesale funds require at least 25.

In determining the number of members, there is a special deeming rule for unit holders known as "qualified investors." Broadly, in recognition of their status as institutional investors, qualified investors are deemed as more than one member, calculated as their percentage interest in the MIT (MIT participation interest) multiplied by 50. For this purpose, one must trace through trusts but not other entities (for example, companies or limited partnerships).

Qualified investors broadly include Australian complying superannuation entities and foreign superannuation funds with at least 50 members, Australian life insurance companies, foreign life insurance companies, other MITs, foreign collective investment vehicles that are regulated and have at least 50 members, specific foreign government pension funds, specific government entities and agencies, and wholly owned subsidiaries of all those entities.

An alternative widely held membership test is also available for retail funds and registered

[1] A lower rate of 10 percent is also available for the income of an MIT considered a clean-building MIT.

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wholesale funds. If the funds don't satisfy their respective member requirements, they will still be considered widely held if qualifying investors hold an MIT participation interest of at least 25 percent and no single nonqualifying investor holds an MIT participation interest of at least 60 percent.

Restriction on Permitted Activities

An MIT's final key qualification requirement is that it must engage only in passive investment, which is failed if either the trust or an entity whose affairs or operations the trust controls conducts activities not considered passive.

Activities considered passive include investing in land primarily to derive rent, as well as investing or trading in a range of specified financial instruments, including loans, bond shares, units, futures, and forwards.

Importantly, trading land is not considered passive, so only investing to derive rent is permitted. The Australian Taxation Office (ATO) interprets that requirement strictly and precludes property trusts from qualifying when features of an investment indicate the primary intention is to derive not rent, but instead gain on sale of the property.

Therefore, an MIT would not suit foreign investors seeking to deviate from the passive activities mentioned above or to control entities that do.

Other Key Qualification Requirements

The MIT has other key qualification requirements. The trust must be a managed investment scheme as defined in section 9 of the Corporations Act 2001 (Cth), which broadly requires that it has at least two members and that members cannot have day-to-day control over the fund's operations.

If the trust is a wholesale fund, the trustee or investment manager must satisfy the licensing requirements in the Corporations Act. Also, the trustee of the trust must be an Australian resident, or the central management and control of the trust must be in Australia.

Finally, the trust must not be closely held – that is, 20 or fewer persons for retail funds, or 10 or fewer persons for wholesale funds, must not have a 75 percent or greater MIT participation interest. Units held by qualified investors are excluded, so a trust can never be closely held if qualified investors own more than 25 percent of the units in the trust. Further, a foreign resident individual cannot have an MIT participation interest of at least 10 percent in the trust. In determining the MIT participation interest of the foreign resident individual, all types of entities must be traced.

Defining Features

The MIT has several other important features. The lower tax rate afforded to foreign investors applies to net rental income and capital gains earned by the MIT when the foreign investor is resident in a country that has a regulated exchange of information agreement with Australia, or the income or gain is not from residential real estate, agricultural assets, or some cross-staple arrangements.[2]

The tax on MIT investors is a final withholding tax payable by the MIT. While that removes Australian compliance obligations for the foreign investor (such as the obligation to prepare an Australian tax return), it also means that any expenses he incurs (such as funding costs) cannot reduce his Australian tax payable.

The concessional MIT withholding rate applies only to MIT distributions; thus, if an investor sells units in the MIT and a taxable gain arises, that gain is ineligible for the concessional rate.

Chinese Investment Tax Structures

Offshore Funds Investment in China

Under enterprise income tax laws in the People's Republic of China, a PRC tax-resident enterprise is subject to PRC enterprise income tax on its worldwide income, and a non-PRC tax-resident enterprise is subject to PRC enterprise income tax only on its PRC-sourced income. An offshore fund is generally considered a non-PRC tax-resident enterprise even if it is incorporated as a limited liability company or a partnership, as long as it is incorporated outside China and does not have effective management in China.

[2] Otherwise, the net rental income and capital gains are taxed at 30 percent.

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If an offshore fund (incorporated as either an LLC or partnership) is considered a tax resident of a jurisdiction that has a tax treaty with China, it would be eligible for treaty benefits. If not, the applicable treaty-based benefits may differ depending on the tax treaty between China and the fund's jurisdiction. Based on the updated interpretation of a partnership's eligibility for treaty benefits, a foreign partner of an offshore partnership cannot claim treaty benefits in China unless specifically permitted under the applicable tax treaty.[3]

Taxing Fund Investment in Chinese Real Estate

An offshore fund's investment in Chinese real estate is typically structured by using multitiered offshore special purpose companies to hold a Chinese project entity (PRC project company). A direct investment in PRC real estate from offshore is not allowed. The PRC project company is commonly formed as a wholly foreign-owned enterprise. If there are two or more investors jointly investing in the same PRC project company, the joint venture platform is usually established outside China.

Taxes Applicable to PRC Project Companies

A PRC project company is liable for a stamp duty of 0.05 percent of the total contractual purchase price for a direct purchase of property, or the company that holds the property. Thus, when a PRC project company purchases a piece of property or purchases a company that owns property, there is a 0.5 percent stamp duty paid by the project company.

Also, if a PRC project company purchases the property directly, on signing the real estate property transfer agreement, it will be subject to deed tax in China on the total transfer price (excluding VAT) at a rate of 3 to 5 percent, depending on the location.

Profit Repatriation

There are several ways to repatriate profits, including dividends and interest, out of China and back to the funds.

For dividend distributions made by a PRC project company, legal and tax requirements in China must be met. As a wholly foreign-owned enterprise, a PRC project company can make dividend distributions only after the following three conditions are satisfied:

- full contribution of the registered capital;
- settlement of the tax payments and completion of the tax filings with the tax authority for the relevant tax year; and
- completion of the foreign exchange control process on outbound remittance; also, as a wholly foreign-owned enterprise, a PRC project company may not distribute any dividends unless it has accumulative profits available for distribution (defined under accounting rules).

Further, before any dividend distributions are made, a PRC project company would normally need to contribute 10 percent of its after-tax net profits into its mandatory legal reserve fund unless the amount accumulated in that fund has reached 50 percent of the company's total registered capital.

Dividend distributions made by a PRC project company to its non-PRC tax-resident shareholder are subject to a 10 percent withholding tax unless reduced by an income tax treaty. If the non-PRC tax-resident shareholder is eligible for tax treaty benefits, it and the wholly foreign-owned enterprise (as a withholding agent) may self-assess and apply the reduced withholding tax rate, then file prescribed forms and supporting documents with the tax authorities.[4]

In general, and as a special regulatory restriction, a wholly foreign-owned enterprise characterized as a real estate company cannot borrow funds from a foreign lender (related or unrelated).

If a cross-border loan is legal, the interest would be subject to 10 percent withholding tax unless reduced by treaty. The interest would also be subject to a 6 percent VAT, which would be withheld by the wholly foreign-owned enterprise. As an exception, VAT paid on interest would not be creditable to the wholly foreign-owned enterprise and would therefore become a cost.

[3] SAT Announcement [2018] No. 11, article 5(2).

[4] SAT Announcement [2015] No. 60.

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For the reasons above, offshore real estate funds typically would not use intercompany financing as a tax-efficient way to repatriate earnings.

Tax-Efficient Exit Strategies

Offshore funds can exit from their real estate investment in China in several ways, including by selling the property owned by the PRC project company, followed by profit repatriation; transferring equity interest in the PRC project company; and transferring equity interest in an offshore special purpose company.

For the first option, a sale of property by a PRC project company would trigger several taxes in China, including:

- an enterprise income tax of 25 percent;
- VAT at 10 percent plus surcharges (12 percent on VAT payable);
- land VAT, which is imposed at progressive rates ranging from 30 to 60 percent, depending on the amount of the value appreciation; and
- a 0.05 percent stamp duty of the total contractual price of the real estate sale.

In comparison, the transfer of equity interest in either the PRC project company or the offshore special purpose company would not trigger land VAT in China, and the enterprise income tax would be reduced from 25 percent to 10 percent. The difference between the direct transfer of the PRC project company and the indirect transfer of the company through the transfer of the offshore special purpose company is that the direct transfer would also be subject to a 0.05 percent stamp duty.

Offshore funds often use multitiered offshore holding companies to invest in China. Because of the Chinese indirect transfer rules, capital gains from the exit are typically subject to a 10 percent Chinese enterprise income tax, regardless of whether the exit takes place onshore or offshore, unless reduced by a tax treaty. A Singaporean holding company with sufficient economic substance may be eligible for treaty benefits, such as the capital gain exemption on the transfer of a minority interest (less than 25 percent) in a Chinese company. Partnership-based treaty benefits are difficult to claim because China's rules on partnership taxation are less developed.

Japanese Investment Tax Structures

Japan is a high-tax jurisdiction with a corporate income tax rate of 34 percent and a dividend withholding rate of 20 percent. High-income individuals are subject to an effective rate of 55 percent on ordinary income. Given the high tax rates, Asian-Pacific funds investing into Japan engage in sophisticated tax planning. The nature of the planning is generally determined by the asset class and the form of returns generated by the investment, as well as the intended exit strategy.

For example, private equity funds whose investments in Japan are expected to be primarily in the form of capital gains realized on exit are generally structured in a manner that allows them to avoid capital gains taxation in Japan. Investors in debt instruments might use a different strategy, structuring their investments to minimize interest withholding taxes and avoid gains on the disposition of the debt by investing through *tokumei kumai* (TK) arrangements, a form of silent partnership structures that can be transferred offshore free of Japan taxation.

Investment funds investing into Japan real estate generally use two structures: investment through a *tokutei mokuteki kaisha* (TMK), which owns the real estate, or through a TK arrangement directly into a Japanese entity that owns the real estate.

Japanese Taxation of the TMK

Corporate Taxation

The effective tax rate for a TMK is approximately 34 percent. A TMK's taxable income is determined in the same manner as that of other Japanese corporations. However, a TMK should be entitled to deduct dividends declared in determining its taxable income in accordance with article 67-14 of the special taxation measures law, if it meets all the following conditions:

- It is registered on the TMK registry book as prescribed under article 8(1) of the asset liquidation law.
- It satisfies one of the following:
  - the aggregate amount of the issue price of its specified bonds that have been publicly offered is at least ¥100 million;

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  - its specified bonds are expected to be held solely by Qualified Institutional Investor (QII);
  - at least 50 investors hold its preferred stocks; or
  - its preferred stocks are held solely by QII.
- Under the Asset Liquidation Plan (ALP), more than 50 percent of both the TMK's common and preferred units will be offered in Japan. The requirement does not apply to common units if common unit holders renounce their right to receive dividends and residual assets.
- Its fiscal year does not exceed one year.
- It conducts its business and its incidental activities in accordance with its ALP as stipulated under article 195(1) of the asset liquidation law.
- It does not conduct any business other than that related to the liquidation of its qualified assets and activities incidental thereto.
- It places the qualified assets in trust or entrusts the management and disposal of its qualified assets to another person.
- It is not a family corporation as defined in the corporate tax law (if the aggregate amount of the issue price of its specified bonds that have been publicly offered is at least ¥100 million or its specified bonds are expected to be held solely by QII, it is exempt from this requirement).
- More than 90 percent of its distributable amount for the tax year has been declared as dividends to its unit holders.
- It is not a general partner of a Japanese general or limited partnership company.
- It does not own any assets other than qualified assets listed in article 200(2) of the asset liquidation law and the ALP. Any borrowings incurred by a TMK can be provided only by a QII, and not by any person who has made a specified investment in the TMK.

On the sale or other taxable disposition of the property, the TMK will realize capital gain or loss equal to the difference between the amount of the consideration it received and its tax basis in the property. A TMK's capital gains are taxable at normal corporate income tax rates. If it qualifies, a TMK should be entitled to claim a deduction for dividends declared that in total are equal to any capital gain recognized. The withholding tax rate applicable to dividends from capital gains is the same as that applicable to dividends from operating income.

Capital gains from the sale of real property should be subject to a 10 percent land surtax if the land has been held for five years or less, or 5 percent if it has been held longer than five years (although the surtax is suspended for sales occurring on or before March 31, 2020). However, under the surtax law, if the TMK meets the dividend deduction requirements, it is not subject to the 5 percent surcharge tax.

If a TMK generates a net loss in any year, that loss may be carried forward to reduce taxable income in the subsequent 10 years if the TMK has blue form taxpayer status and timely files its tax returns.[5]

Consumption Taxation

A TMK is generally treated as a consumption taxpayer if it does not have a base year — that is, the fiscal year two years before the current fiscal year — and its stated capital is at least ¥10 million at the beginning of the current fiscal year;[6] its taxable sales in the base year are more than ¥10 million; or it has filed a tax report to elect to be a consumption taxpayer with the relevant local tax office.

The consumption tax rate is 8 percent, which applies to the sale of a building (or of the beneficial trust certificate representing a beneficial interest in a building). Rents on a residence and the sale of land (or of the beneficial trust certificate representing a beneficial interest in a land) are not subject to consumption tax.

If a TMK is a consumption taxpayer, consumption tax paid can be creditable against

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[5] A blue form return filer is an entity that maintains its accounting records in accordance with Japanese generally accepted accounting principles and has obtained approval from the tax authorities to file a blue return.

[6] A corporation that does not have a base year and whose stated capital is less than ¥10 million at the beginning of the current fiscal year can be considered a newly established small corporation that is treated as a consumption taxpayer if it meets the following requirements:

- as of the beginning of either of its first two fiscal years, it is more than 50 percent owned by a corporation whose taxable sales (or those of its related parties) in the base year exceeds ¥500 million; and
- it is established on or after April 1, 2014.

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consumption tax received, depending on the TMK's taxable sales ratio. If the creditable amount exceeds the amount received, the excess will be refunded.

Japanese Taxation of Singaporean Companies

Investments in Japanese real estate by funds are often structured through a TMK owned by Singapore subsidiaries of the fund managed in a manner that allows a Singaporean corporation to claim the 5 percent dividend withholding tax rate under the Japan-Singapore treaty. Those kinds of structures can result in the fund realizing effective tax rates ranging from 6.5 to 13.5 percent for real estate investments in Japan.

A Singaporean corporation, as a Singaporean private limited company, should be treated as a foreign corporation for Japan income tax purposes. Thus, dividends paid by a TMK to a Singaporean corporation for preferred units will be subject to a withholding tax rate of 20.42 percent on their gross amounts under domestic tax law.[7] That rate can be reduced to 5 percent[8] under the Japan-Singapore tax treaty if the Singaporean corporation qualifies as a resident of Singapore, is the beneficial owner of the dividend, and owns at least 25 percent of the TMK's voting shares during the six months immediately before the end of the accounting period in which the distribution takes place.

Japan and Singapore have signed the MLI (although only Japan has ratified it), and both opted for the principal purpose test for the prevention of treaty abuse in article 7. To safely claim Singapore's reduced dividend withholding tax rate, the structure must meet that test. The MLI mandated revisions to the Japan-Singapore tax treaty will enter into force on April 1.

Japan taxes capital gains realized by foreign persons who sell the shares of a Japanese company that holds at least 50 percent of the value of its assets in the form of Japanese real estate if, immediately before the tax year in which the sale occurs, those foreign investors owned more than 2 percent (5 percent if the company is listed) of the shares in that Japanese company (1980 Foreign Investment in Real Property Tax Act).

Foreign persons who are subject to capital gains tax but do not have a PE in Japan would be taxed at approximately 25 percent. Because a TMK will hold primarily Japanese real estate and the Singaporean corporation will hold more than 2 percent of the TMK's units, Japan's FIRPTA will apply to the Singaporean corporation's sale of the TMK's common and preferred equity units.

Japanese Taxation of TK Arrangements

A TK relationship is based on a contractual agreement between the operator of the business in Japan and an investor who agrees to provide cash or assets for use in the business. Under the Japanese commercial code, assets and liabilities of the business are solely those of the operator — that is, the investor has no ownership interest in the assets or any liability for obligations of the business. Further, the investor must be a silent partner.

In contrast to the TK arrangement, a *ni-nin kumai* (NK) is a partnership formed under Japanese civil law to carry out the mutual goals of its partners. Its partners jointly own its assets, are severally liable for its obligations, and may jointly participate in management and decision-making.

An important distinction between TK and NK arrangements is the degree of the investor's participation in management and the decision-making. If the TK investor and the operator in Japan abide by the terms of the TK agreement (that the operator holds the property of the business in its own capacity as the operator, and has the sole right to manage the business and make all actions, decisions, consents, approvals, determinations, and elections), the TK investment structure should be respected as valid.

However, if the TK investor participates directly or indirectly in the management or decision-making of the operator's business, the Japanese tax authorities could attempt to recharacterize its status as a partner in an NK. If the tax authorities successfully do so, the foreign TK investor and the operator in Japan would be treated as partners in the NK, in which case the foreign TK investor will be treated as having a PE in Japan and will be subject to national and local corporate tax of approximately 34 percent on its allocable share of the TK's profits or gains.

[7] In addition to the 20 percent withholding tax, a special reconstruction income tax of 2.1 percent will be imposed until December 31, 2037.

[8] The special reconstruction tax does not apply to the tax treaty rate of 5 percent.

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Singaporean Limited Partnerships

Japan's tax law does not contain foreign entity classification rules, but case law provides guidance on how a Singaporean limited partnership should be characterized for Japanese tax purposes.

On July 17, 2015, the Supreme Court of Japan ruled that a limited partnership established under the laws of the U.S. state of Delaware should be treated as a corporation for Japanese tax purposes in some cases. The Court said an entity should be examined under the foreign country's laws to establish whether it would receive the status of a legal person under Japanese law. If that cannot be determined, the entity's nature should be determined based on whether it has rights and obligations under the foreign country's relevant laws by examining the legislative purpose or context of the governing law.

Based on their legal characteristics, Singaporean limited partnerships should be treated as passthrough entities rather than corporations for Japanese tax purposes.

South Korean Investment Fund Tax Structures

Savvy global real estate investors have long been aware of potential investment opportunities in the Korean real estate market. However, when compared with other Asian countries, the tax costs associated with investing in and exiting from Korea have proven a major challenge. Moreover, recent tax trends driven by the BEPS action plans and the current administration's neutral stance regarding foreign direct investment have resulted in the elimination or reduction of many tax incentives that used to benefit foreign real estate investors.

That said, a foreign investor using a well-developed investment structure that includes careful consideration of the potential taxes that can arise from investing in Korean real estate may avoid the pitfalls of prohibitive or duplicative taxes.

Treaty Planning

Like many developed countries, South Korea has a vast tax treaty network. For investing in Korean real estate, some of those treaties work better than others to avoid PE status and eliminate or reduce withholding taxes on interest, dividend, and capital gains. However, as is the recent global trend, Korean tax authorities will scrutinize tax treaty structures to determine if the treaty claimant is entitled to treaty benefits. The main focus tends to be on whether the treaty claimant has sufficient substance in the jurisdiction where it is a tax resident such that it can be regarded as the beneficial owner of the income or gains under the Korean withholding tax rules.

Accordingly, any attempt to design a structure as an afterthought — for example, by establishing an entity (Newco) in a tax treaty jurisdiction and then transferring or assigning the buyer's rights in or ownership of Korean assets to Newco following negotiations with a seller from a third country — is likely to viewed as an artificial arrangement used to treaty shop that will thus be disregarded for Korean tax purposes. The result is that any income or gain of the Korean investment will not be viewed as beneficially received by Newco. Instead, Newco's shareholders or ultimate investors will be considered the beneficial owners, which could result in full domestic capital gains taxation in Korea, which in turn would trigger withholding tax and other compliance requirements. Moreover, under the MLI, which South Korea has signed, that kind of structure would fail the principal purpose test and the limitation on benefits provisions designed to prevent treaty abuse.

Given recent global trends, it would not be surprising if all tax treaty structures faced aggressive audit by the Korean tax authorities. Hence, it is of paramount importance that the treaty claimant meet the substance requirements for beneficial ownership.

For Korean tax purposes, substance involves more than legal and economic concepts in the general OECD sense. It also requires:

- physical substance, such as office and other facilities demonstrating capability to manage investments in Korea;
- sufficient human resources to manage investments in Korea; and
- sufficient communication, interaction, and oversight by the treaty claimant demonstrating management and control of the investment (if the paper trail leads to an entity in a third country, the treaty claimant

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could be treated as established solely for tax purposes and thereby denied any tax treaty benefits).

Amending the Overseas Investment Vehicle Rule

Often an overseas fund based in one jurisdiction establishes a holding company structure in another jurisdiction for nontax reasons but then finds itself in a worse tax position than if it had invested directly.

An overseas investment vehicle (OIV) is similar to a collective investment vehicle and is broadly defined as an overseas legal entity designed to raise or collect funds through an investment offering that manages investment assets, derives value from the acquisition and disposition of assets, and distributes income or gain from investments to its investors. Hence, partnerships, LLCs, and other types of noncorporate collective investment vehicles should qualify as OIVs.

The OIV rule was promulgated in 2012 to allow look-through treatment for OIVs established in non-tax-treaty jurisdictions, thus allowing their ultimate investors to claim treaty benefits available under the treaties between their jurisdictions and South Korea. However, the Korean Supreme Court ruled that an offshore fund established in the Cayman Islands to raise funds and invest them in Korea can be treated as the beneficial owner of Korean-source income. And because the Cayman Islands does not have a tax treaty with South Korea, the Korean-source income was fully taxable at the domestic rate.

Consequently, the South Korean tax authorities begin to test whether a Cayman Islands entity should be treated as the beneficial owner, while disregarding the beneficial ownership principle the Korean tax authorities had developed for determining whether a foreign person can be entitled to treaty benefits and if not, allowing a look-through to the ultimate investors.

To remove that double standard for OIVs established in jurisdictions such as the Cayman Islands, the South Korean Ministry of Economy and Finance (MOEF) revised the OIV rule in late 2018 (effective beginning January 1, 2020). Under the new rules, an OIV can be treated as a corporate entity for Korean tax purposes only if any of the following three conditions are met:

- it has legal personality (for example, indefinite life) under the law of the country where it was incorporated;
- it has only partners or members with limited liability; or
- it has the same or similar characteristics to a company as defined under the Korean commercial code.

Hence, the fact that an entity can hold assets, be a party to a lawsuit, or have rights and obligations separate from its members or partners will no longer result in it being treated as a corporate entity (and potentially as the beneficial owner of Korean-source income). Moreover, the MOEF has said the character of Korean-source income earned by a noncorporate foreign entity is retained and tested at the level of each investor.

If, for example, an OIV discloses only some of its partners or investors, only that portion of the income would be taxed at the investor level — the remainder would be taxed at the OIV level. The MOEF has also said that so long as an OIV is a company type — that is, not a trust or partnership type — it will be treated as the beneficial owner if it is liable to tax in its jurisdiction of residence, was not established to avoid or reduce tax on Korean-source income, or is respected as the beneficial owner under an applicable tax treaty.

Regarding the first condition, it seems the OIV amendment was designed to override the Supreme Court's decision referred to above. The second condition appears designed to remove the double standard in determining whether an entity is a beneficial owner when it is established in a tax treaty jurisdiction.

Domestic Structuring for Real Estate Investments

The direct acquisition of South Korean real estate by a foreign investor is not tax efficient from a Korean tax perspective because it can trigger PE risk (corporate-level tax) and in some cases, the branch profits tax. Considering the recent tax law changes that have resulted in the increase of the top marginal corporate income tax to 27.5 percent (including local tax) and the potential exposure to Korean legal and regulatory risks, sophisticated investors are likely to establish a tax-efficient Korean legal vehicle to hold its Korean real estate.

Foreign investors could establish a Korean entity under the Korean commercial code to hold

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and operate the real estate investment (Opco). Generally, that structure would lead to those investors being subject to two layers of taxation in Korea: the potential top marginal rate of 27.5 percent at the Opco level, then a domestic statutory withholding tax rate of 22 percent when the Opco distributes its earnings by way of dividends (or interest).

However, for qualified real estate investment, if Opco were to be established in compliance with the Financial Investment Services and Capital Markets Act (FISCMA) and approved by the Financial Supervisory Service, it would be entitled to a special dividends paid deduction. If Opco declares or distributes dividends of not less than 90 percent of its distributable income for accounting purposes, the amount would also be deductible against Opco's taxable income. While some taxable income may remain if there is any book or tax difference (and setting aside the legal reserve required under the Korean commercial code), the availability of a dividends paid deduction would generally mean that Opco would be exempt from Korean corporate income tax.

An alternative structuring option would be to establish an investment trust rather than a company. Although it would still be governed and regulated under FISCMA, the entity would be a nontaxable passthrough vehicle, often preferred by real estate investors. There is, however, a concern regarding whether a distribution from a trust would qualify for the lower withholding rate on dividends available under many treaties. Still, in addition to avoiding the 0.48 percent (1.44 percent in some cases) capital registration tax payable on the amount of par value of shares registered with the court as paid-in-capital for corporate entities, and not being subject to any legal reserve requirement, an investment trust is considered easier and less costly to establish and operate. However, use of leverage is permitted only in specific cases.

Other investment vehicles can be established under different bodies of law to allow for passthrough treatment for corporate income tax purposes, but are not as popular as the structures discussed above.

Exit and South Korean CGT Considerations

Historically, foreign investors exit from their investments in Korea by selling shares in Opco. Generally, the domestic capital gains rate, at the lesser of 11 percent of gross proceeds or 22 percent of net capital gains, can be avoided under tax treaties if the seller meets the beneficial ownership test. However, most modern Korean tax treaties allow the Korean tax authorities to tax the gains from disposition of shares of companies rich in Korean real estate.

Moreover, unless treaty-protected, those shares are taxed similarly to gains realized by a South Korean PE — that is, subject to corporate income tax of up to 27.5 percent. Accordingly, the better option may be for Opco to sell its real estate investment and then repatriate all the gains as dividends to its treaty-based shareholders. In that case, the dividends would generally be subject to withholding tax of 5 to 15 percent (under most Korean tax treaties).

Following the complete distribution of earnings, Opco could then be liquidated, which would allow the investment principal to be repatriated to the shareholder free of any further Korean tax. Under that structure, the entire tax leakage of profits generated from Korean real estate investment would be between 5 and 15 percent. And in many cases, given the low level of foreign taxes — that is, withholding tax – paid in Korea, foreign tax credits may also be available in the jurisdiction where the shareholder or holding company is located, or where the ultimate investors of the holding company reside.

Conclusion

In response to recent significant tax developments and negative public perceptions of offshore tax havens such as the Cayman Islands, fund tax advisers to Asian investment funds are increasingly considering Asia-Pacific funds established in Singapore. For investment funds with an Asia-Pacific mandate or with local investment management presence in Asia, a Singapore funds structure provides a compelling solution. Singapore has an attractive funds tax regime, an extensive tax treaty network, and a respected investment management regulatory regime. All forms of Singapore funds (including the VCC) provide a tax-efficient and low-risk platform for investments into Australia, China, Japan, and South Korea. ■

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