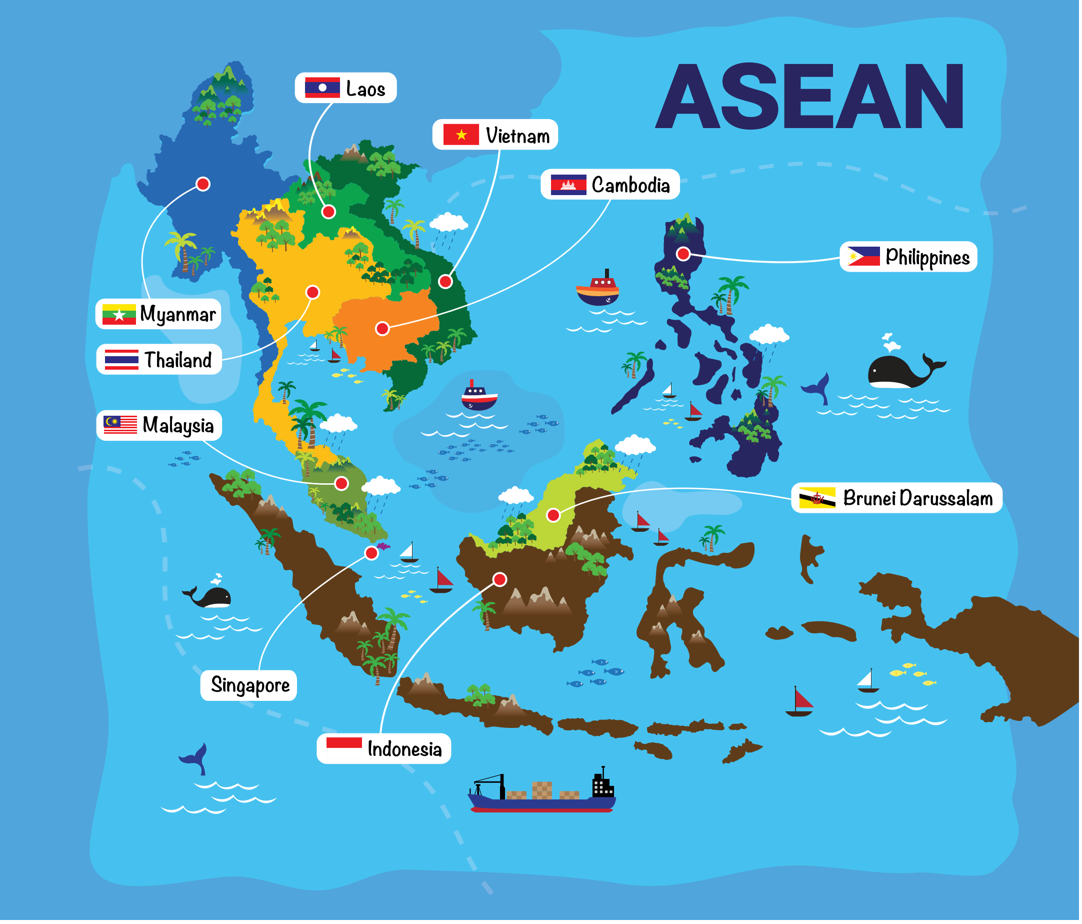

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Tax-Advantaged Investing in Booming ASEAN Economies

By Robert W. Wood and Huy C. Luu

Investors venturing into foreign lands for acquisitions or investments may seek stellar returns, enhanced by a mixture of attractions that is hard to define. Structuring a deal may be daunting in the fluid legal and regulatory environment of an emerging economy. They are far less established and regulated than Americans are accustomed to seeing. For some investors, the tax impact of a transaction may be an afterthought or may not be considered at all. Taxes should be considered in any investment, foreign or domestic. That is certainly true with investment into members of ASEAN (the Association of Southeastern Asian Economies), which is comprised of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. To avoid unpleasant tax surprises, investors in these emerging Asian economies should plan their structures carefully.

Tax Treaty Considerations

Tax treaties often play a critical role in cross-border transactions. Investors want to maximize profits in a tax-efficient manner without leaving too much cash trapped in the jurisdiction. Investors should understand the tax implications on profit repatriation and potential future capital gains on the investment.

Some of the typical checklist issues to consider include:

- Whether paying dividends (or other profit repatriation measures) will attract withholding tax in the host jurisdiction (i.e., the jurisdiction of the entity that is making the payments);
- Whether the receipt of foreign dividends or other foreign source income by the investor will be subject to tax in the investor's home jurisdiction;
- Whether mechanisms can be put in place to minimize the effect of double taxation;
- The capital gains tax impact on a future divestment of the investment.

With all of these concerns, investors should analyze applicable tax treaties to determine whether taxes can be minimized. If the investor is a U.S. resident, the investor should see if the U.S. has concluded a tax treaty with the host jurisdiction. Without a tax treaty, the taxes in the host jurisdiction and the investor's jurisdiction may result in double taxation on any profits.

Example:

> A U.S. company has investments in Indonesia. Upon earning profits, the Indonesian entity distributes dividends. The withholding tax rate for dividends to a non-resident of Indonesia is 20%. Thus, if the dividend payment is $100, the Indonesian entity must withhold $20 and send $80 to the U.S. investor. Upon receipt of the net $80 in dividends, the investor must also pay U.S. tax.

Fortunately, under the U.S. tax treaty with Indonesia, the maximum withholding tax rate for dividends is 15%. As a result, Indonesia's 20% withholding tax is reduced to 15%.[1]

If the U.S. investor sells its shares in the Indonesian entity, the gain (if any) would be taxed at Indonesia's 25% ordinary income rate. However, the U.S.-Indonesia tax treaty exempts the U.S. investor from paying taxes on capital gains in Indonesia. The result is that only the U.S. may impose tax on the gain.[2]

Most tax treaties contain a clause providing relief from double taxation. In general, if the U.S. imposes taxes on the same income that was subject to tax in the foreign jurisdiction, a tax credit is generally permitted to provide relief from double taxation.[3]

The Internal Revenue Service provides a list on its website of U.S. tax treaties that are currently in effect.[4]

Administrative Hurdles

Tax treaty benefits in many Asian jurisdictions are not always automatic. Indonesia, for example, requires foreign investors to complete relevant forms and detailed questionnaires and to submit them to the Indonesian tax authorities. Vietnam requires notification to the tax authorities that the foreign investor is claiming entitlement under a tax treaty.

Moreover, the investor must generally obtain a tax residency certificate in the investor's home jurisdiction. In some countries, there are timing constraints as well, with treaty benefits conceivably being lost because the foreign investor is not timely in making requisite treaty benefits claims.

Some jurisdictions have anti-tax avoidance rules that may give tax authorities discretion to deny treaty benefits if they determine that the recipient is not the true beneficial owner of the payments. This latter danger can sometimes loom large with complex structures.

Direct or Indirect Holdings?

There are many reasons a U.S. investor may decide not to hold an interest in a foreign company directly. The U.S. investor may want to employ an intermediary foreign entity. In the context of emerging Asian economies, a typical intermediary company would be located in either Singapore or Hong Kong.

Both Singapore and Hong Kong offer tremendous tax benefits for offshore investments. For one thing, the receipt of foreign dividends by the investor generally does not trigger taxation (subject to certain conditions). Another tax benefit is that neither Singapore nor Hong Kong has a capital gains tax.

There are operational tax advantages, as well. Corporate income tax rates in Singapore (17%) and Hong Kong (16.5%) are relatively low when compared to other developed jurisdictions. Both jurisdictions are stable, predictable, and easy to navigate.

Moreover, Singapore and, to a lesser extent, Hong Kong, have concluded tax treaties with most emerging Asian economies. Many of Singapore's tax treaties include a favorable clause with respect to capital gains. Under a typical provision, only the state in which the transferor is a resident (i.e., Singapore) is allowed to impose capital gains tax on the transaction.[5] This is significant because, as noted, Singapore does not impose any capital gains tax.[6]

Example:

> A U.S. investor uses a Singapore intermediary to acquire a company in Vietnam. Under Vietnam's tax law, the payment of dividends by the Vietnamese entity to the Singapore intermediary is not subject to withholding tax in Vietnam. In addition, dividends received by the Singapore intermediary are not taxable in Singapore.
>
> What if the Singapore entity sells the investment in Vietnam at a gain? Normally, there would be a capital gains tax in Vietnam. However, the Singapore-Vietnam tax treaty only permits *Singapore* to tax the gains (as long as the Vietnamese company does not principally hold immovable property).[7] As a result, Vietnam is not allowed to impose *any* tax on the sales transaction, and Singapore does not have a capital gains tax.

Despite this impressive example, one should use caution with intermediary companies in Singapore, Hong Kong, etc. One should also consider the tax consequences under the U.S.-controlled foreign corporation (CFC) rules.[8] They would capture Subpart F income of the intermediary company.

Of course, under U.S. law, there would generally be an immediate tax on the income in the U.S. With proper U.S. tax planning (such as check-the-box rules) the risks imposed by the CFC rules can often be mitigated. But one must plan ahead to avoid an unpleasant surprise.

Another word of caution: both Singapore and Hong Kong adhere to a general anti-tax avoidance stance. Neither wants to be seen as a tax haven. An investor should not employ a mere conduit or shell company in Singapore or Hong Kong to take advantage of tax treaty benefits. The transaction and the entity should always have economic substance. Economic substance may include having operational activities, having employees, filing tax returns, having a physical office, etc.

BIT Considerations

Another consideration for U.S. investors is the investment protection of their interests in foreign jurisdictions. Such concerns are often palpable, particularly in an emerging market where the rule of law may not be consistently applied. Investment protection typically comes in the form of a bilateral investment treaty (BIT).

A BIT is meant to encourage investments between the signatory countries. Moreover, it is also meant to protect the investment interest(s) of the foreign investor. A BIT generally includes clauses relating to national treatment. A foreign investor must be treated fairly, and in the same manner as a domestic investor.[9] A BIT also includes a clause limiting expropriation by the foreign government.[10]

The U.S. has concluded a number of BITs with other countries. Curiously, though, very few are in Asia.[11] Thus, a U.S. investor that plans to invest directly into a region where no BIT has been concluded (for example, Southeast Asia) would not be guaranteed certain investment protection afforded under the BITs to which the U.S. is a signatory.

Intermediary BIT Shopping?

In certain cases, one can invest through another entity in a jurisdiction that *has* concluded a BIT with the host country. In the context of emerging Asian economies, an investor may consider the ASEAN Comprehensive Investment Agreement (ACIA).

ACIA is a type of BIT among the ASEAN countries that protects foreign investments in certain industries, such as manufacturing, agriculture, fishery, forestry, mining and quarrying, as well as other types of investments to which the member states agree.[12] The ACIA includes clauses regarding national treatment[13] and expropriation[14] that are similar to the U.S. Model Bilateral Investment Treaty provisions.

Although taxation is not explicitly addressed in the ACIA, it may be applied indirectly. For example, the national treatment clause would require the foreign jurisdiction to treat domestic and foreign investors in the same manner. Arguably, that nondiscrimination would include application of the tax laws.

Domestic Tax Considerations

There is much talk today of prevailing corporate tax rates. In order to attract more foreign investment, many emerging markets in Asia have recently reduced their corporate income tax rates. Some of the emerging markets offer additional tax incentives in an effort to compete with more stable and developed Asian economies, such as Singapore and Hong Kong.

Thus, U.S. investors should not be focused solely on tax treaties and BITs. Understanding the domestic tax landscape is also important. Different jurisdictions may have different tax incentives that could be attractive.

One notable incentive offered by some jurisdictions in Asia is the regional operating headquarters (ROH) incentive. Multinational corporations tend to focus their regional headquarters in Singapore or Hong Kong due to attractive tax benefits. These include low corporate income tax rates, no capital gains tax, and an exemption on foreign-source income.

There are changes occurring here, as well. In an effort to remain competitive and to lure foreign companies to establish their headquarters there, Thailand implemented a comprehensive ROH regime.[15] It offers tax incentives to foreign investors designed to make Thailand competitive with other regional hubs.

Malaysia has a comparable ROH regime referred to as the principal hub tax incentive regime.[16] It provides tax incentives to companies using Malaysia as a base for conducting regional and global operations.

Another incentive some jurisdictions offer is tax exemption for certain projects located in lesser developed areas. For example, Vietnam has moved to encourage investments in rural and economically disadvantaged areas.[17] The government is empowered to provide attractive tax incentives for investing into such regions for a stated length of time.

In Myanmar, economic development stalled for more than six decades due to military dictatorships. However, the country has recently opened to foreign investment. Myanmar now offers tax incentives for certain new investments approved by the Myanmar Investment Commission.[18]

Cambodia may also be attractive, as it provides for tax incentives for projects that meet certain investment thresholds. Curiously, though, the tax incentives are not available for investments on a so-called "negative list" proscribed by the government.[19]

Good, Bad or Ugly?

There are so many different tax incentives in the ASEAN region that the hopscotch can at times seem random. The changing patterns clearly prove the importance of understanding the local tax landscapes when investing there. From a tax viewpoint, not all countries are created equal.

Moreover, some jurisdictions may have larger international exposures than others, and some may be better equipped to handle complex tax matters. In addition, one jurisdiction may have specific incentives that are not available in neighboring countries.

It is a useful reminder that there is usually a mixture of considerations in the region. Benefits one may receive with one hand may be deprived with another. And since an environment can change, there is an inevitable focus on the timeline for an investment. There must be some recognition that in emerging economies and shifting legal environments, things can change.

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Conclusion

Direct, indirect, wholly owned or fractional joint venture? However and wherever one does it, dipping a toe into a foreign jurisdiction can be exciting. Even relatively small investments can yield significant profits for an investor.

However, planning and local knowledge are key. If the investment is not carefully planned from a tax perspective, the consequences may be unimpressive, perhaps even disastrous. The very nature of cross-border transactions involves multiple sets of laws often laced together with tax and other treaties. Investors should consult savvy tax advisors, and be wary of paths that appear to be too well-worn.

Yet, they should also be careful about going down paths that have never been tread. And wherever possible, they should make contingency and repatriation plans. Legal, political, and tax matters can change quickly, and being nimble pays dividends. By observing these rules, investors can earn handsome returns on their investments in emerging economies. ■

1. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, U.S.-Indonesia, art. 11, July 11, 1988.

2. *Id.*, art. 14(2).

3. *See* U.S. Model Income Tax Convention, art. 23, Nov. 15, 2006.

4. www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z.

5. *See* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to the Taxes on Income, Singapore-Thailand, art. 13(3), Apr. 27, 1976; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Singapore-China, art. 13(6), July 11, 2007; Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Singapore-Vietnam, art. 13(5), Sept. 9, 1994.

6. *See* https://www.iras.gov.sg/IRASHome/Individuals/Locals/Working-Out-Your-Taxes/What-is-Taxable-What-is-Not/Gains-from-Sale-of-Property--Shares-and-Financial-Instruments/; *see also* Singapore Income Tax Act, § 10(1) (imposing income tax on profits that are income in nature, not capital in nature).

7. *See* Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Singapore-Vietnam, art. 13, Sept. 9, 1994, amended by the Second Protocol, Jan. 11, 2013 (providing, in part, that:

> 4. Gains derived by a resident of a Contracting State from the alienation of shares, other than shares of a company quoted on a recognized stock exchange of one or both Contracting States, deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.
>
> 5. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 shall be taxable only in the State of which the alienator is a resident.).

8. Internal Revenue Code §§ 951–964.

9. 2012 U.S. Model Bilateral Investment Treaty, art. 3.

10. *Id.*, art. 6(1).

11. A full list of BITs concluded by the U.S. is available at www.state.gov/e/eb/ifd/bit/117402.htm.

12. ASEAN Comprehensive Investment Agreement, art. 3, Feb. 26, 2009.

13. *Id.*, art. 5.

14. *Id.*, art. 14.

15. *See* Royal Decree No. 405, Dec. 22, 2001.

16. *See* Malaysia 2015 Budget.

17. *See* Circular No. 78/2014/TT-BTC, June 18, 2014, as amended and supplemented by Circular No. 96/2015/TT-BTC, July 1, 2015.

18. *See* Foreign Investment Law, Feb. 24, 2015; Union Parliament Law No. 21, Nov. 2, 2012.

19. *See* Law on Taxation (1997, as amended in 2003); Sub-Decree No. 111 (2005).