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Investing In 'China Plus One' Economies

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Investors are increasingly taking note of emerging Asian economies. Many multinational companies adopt a "China-plus-one" strategy to supplement their investments in China. U.S. investors should properly structure their transactions from a tax perspective in these emerging Asian economies.

Tax treaties often play a critical role in cross-border transactions. Investors want to receive profits in a tax-efficient manner without have too much cash trapped in the foreign jurisdiction.

Example: A U.S. investor has investments in Indonesia. Distribution of dividends to a non-resident is subject to a withholding tax rate of 20 percent in Indonesia. Thus, if the dividend payment is $100, the Indonesian entity must withhold $20 prior to making the net payment of $80 to the investor. Upon receipt of the net dividends, the investor would also be subject to tax in the U.S. Fortunately, under the tax treaty between the U.S. and Indonesia, the maximum withholding tax rate on dividends is 15 percent, so the 20 percent withholding rate is reduced to 15 percent.

Tax treaties typically provide relief from double taxation. If the U.S. imposes taxes on the same income, a tax credit generally provides the needed relief. Fortunately, the U.S. has tax treaties with many of the emerging Asian economies, notably Indonesia, Thailand and Vietnam.

Administrative Hurdles

Still, many jurisdictions in Asia do not automatically provide tax treaty benefits despite the existence of a tax treaty. 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 tax treaty provisions apply. If you do not claim it, you cannot qualify.

Moreover, the investor must usually obtain a tax residency certificate in the investor's home jurisdiction. In some countries, treaty benefits may be denied because the foreign investor is not timely in making the requisite treaty benefits claims. Some jurisdictions have anti-tax avoidance rules that may give the 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 Investment

For various reasons, a U.S. investor may want to employ an intermediary foreign entity to hold its investment. With emerging Asian economies, a typical intermediary would be located in Singapore or Hong Kong, both of which have attractive tax benefits. Moreover, Singapore, and to a lesser extent Hong Kong, have favorable tax treaties with most of the emerging Asian economies.

But be careful with intermediary companies in any foreign jurisdiction, including traps under the U.S.-controlled foreign corporation (CFC) rules. They would capture and immediately tax so-called "Subpart F income" of the intermediary company (which typically consists of any type of passive income). With proper U.S. tax planning (such as the U.S. check-the-box rules that allow you to pick which entities to have treated as taxable, and which to disregard and treat as a conduit), the risks imposed by the CFC rules can be managed.

Singapore and Hong Kong require the transaction and the intermediary entity to have economic substance. One cannot employ a mere conduit or shell company to take advantage of tax treaty benefits.

Another consideration for U.S. investors is the investment protection of their interests in a foreign jurisdiction. Investment protection typically comes in the form of a bilateral investment treaty (BIT).

BITs are meant to encourage investments between the signatory countries, and to protect the investment interests of the foreign investor. A BIT generally includes clauses relating to national treatment, which states that a foreign investor must be treated fairly, in the same manner as a domestic investor. A BIT also includes a clause limiting expropriation of the investment by the foreign government.

The U.S. has *some* BITs, but very few with Asian jurisdictions. Thus, if a U.S. investor plans to invest directly into a region where no BIT has been concluded (for example, Southeast Asia), there is no guarantee that its investments will be protected.

BIT Shopping?

It may be beneficial to invest through another entity in a jurisdiction that *has* concluded a BIT with the host country. It is a kind of treaty shopping. An investor may consider the ASEAN Comprehensive Investment Agreement (ACIA), which is a type of BIT among the ASEAN countries. ACIA protects foreign investments in industries such as manufacturing, agriculture, fishery, forestry, mining and quarrying. The ACIA also includes clauses regarding national treatment and expropriation. They are similar to the clauses under the U.S. Model Bilateral Investment Treaty. 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. Such planning can sometimes offer legal or tax protection indirectly that one cannot get directly.

Domestic Tax Considerations

There is much talk today of the high U.S. corporate tax rates. To attract foreign investment, many emerging markets in Asia have recently reduced their corporate tax rates. A U.S. or other foreign investor should not focus solely on tax treaties and BITs. Considerations given to the domestic tax landscape can also be beneficial.

For example, one notable incentive some Asian jurisdictions offer is the regional operating headquarters (ROH) regime. Thailand implemented a comprehensive ROH regime to offer tax incentives designed to make Thailand competitive with other regional hubs. In Vietnam, tax exemption is provided for certain projects in rural and economically disadvantaged areas. The government provides attractive tax incentive benefits for investors into such regions for a stated length of time.

In Myanmar, economic development stalled for decades due to military dictatorship. However, the country recently passed the Foreign Investment Law, offering tax incentives for new investments approved by the government.

There is usually a mixture of considerations in the region. Benefits one receives with one hand may be taken away with another. And since the environment can change, there is an inevitable focus on the timeline for an investment. In emerging economies and changing legal environments, things can change.

Conclusion

Diversifying investments into emerging Asian economies can yield significant profits for investors. However, planning and local knowledge are key. If the investment is not carefully planned from a tax perspective, the consequences may be unimpressive or even disastrous.

An investor in China should not assume that investment in the neighboring countries will be the same. It is prudent to consult savvy tax advisors, and wherever possible, to make contingency and repatriation plans. Fortunately, with a little planning, the emerging economies and foreign investors can all emerge as winners.

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