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Taxing Investments in Emerging Asian Economies

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Investors often feel the allure of venturing into a foreign land to explore potential acquisitions or investments. The pull is surely financial, as some of the opportunities may provide stellar returns. But they may be enhanced by a mixture of attractions that is hard to define. Counterintuitively, some of the interest is because of the range of legal and cultural difficulties.

Structuring a deal may be a daunting task in light of the prevailing legal and regulatory environment, particularly in an emerging economy. With typically far less that is established and regulated than Americans are accustomed to seeing, the transactional environment can be quite fluid. For some investors, the tax impact of a transaction may be an afterthought or not considered at all.

This can lead to disastrous consequences. This article addresses some of the considerations that investors should take into account to properly structure their transactions in the emerging Asian economies from a tax perspective.

In recent years, there has been a global economic shift towards the Asian economies, which have been the primary driving force behind the worldwide economic growth. Investors are increasingly taking note of the emerging Asian economies as alternatives to China. Yet just as these emerging economies are opportunities for outsized growth and untapped markets, they are developing in many ways.

That includes their tax systems. There are ever-changing tax regimes in many of these emerging economies. In many cases, there are still vast local differences between different parts of a single country, and the impact can be large.

Even administratively, there may be marked inconsistencies of practice by the tax authorities across borders and within the borders of a single country. For all these reasons, it is crucial for investors to understand the particular tax environment they will face. They not only should understand the basics in place now, but also how the overall tax picture may change over time and the impact it may have on their potential investments.

Tax Treaty Considerations

The application of tax treaties often plays a critical role in tax planning for cross-border transactions. The goal of an investor is to maximize profits in a tax-efficient manner without having too much cash trapped in the host foreign jurisdiction where the investment is located. Thus, an investor needs to understand the tax implications for profit repatriation and potential future capital gains on the investment.

Some of the typical checklist issues to consider include the following:

- Will the payment of dividends (or other profit repatriation measures) attract withholding tax in the host jurisdiction (*i.e.*, the jurisdiction of the entity that is making the payments)?
- Will the receipt of foreign dividends or other foreign-source income by the investor be subject to tax in the investor's jurisdiction?
- Are there mechanisms in place to minimize the effect of double taxation?
- What about the capital gains tax impact on a future divestment of the investment?

With all of these concerns, the investor would need to carefully analyze the applicable tax treaty to determine whether taxes can be reduced or minimized. Assuming that the investor is a U.S. resident, the investor would need to see if the United States has concluded a tax treaty with the host jurisdiction. Without a tax treaty in place, the taxes imposed in the host jurisdiction, as well as in the investor's jurisdiction, may result in double taxation and may eat up profits generated from the investment.

Example: A U.S. investor has investments in Indonesia. Upon earning profits, the Indonesian entity distributes dividends to the investor. The withholding tax rate for payment of dividends to a nonresident of Indonesia is 20 percent. Thus, if the dividend payment is $100, the Indonesian entity must withhold $20 prior to making the net payment of $80 to the U.S. investor. Upon receipt of the net $80 in dividends, the investor would also be subject to tax in the United States.

Fortunately, under the tax treaty between the United States and Indonesia, the maximum withholding tax rate that Indonesia may impose for dividend payment is 15 percent. As a result, the 20-percent withholding tax rate in Indonesia would be reduced to 15 percent. Accordingly, Article 11 of the tax treaty provides that:

(1) Dividends derived from sources within one of the Contracting States by a resident of the other Contracting State may be taxed by both Contracting States.

(2) However, if the beneficial owner of the dividends is a resident of the other Contracting State, the tax charged by the first-mentioned State may not exceed 15 percent of the gross amount of the dividends actually distributed. [*The Convention Between the Government of the United States of America and the Government of the Republic of Indonesia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Article 11.]

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If the same U.S. investor divests of its shares in the Indonesian entity, the gains (if any) would be taxed at the ordinary income rate of 25 percent in Indonesia. The U.S.–Indonesia tax treaty, however, exempts the U.S. investor from paying taxes on capital gains in Indonesia. The result is that only the United States may impose tax on the gains. The treaty provides that:

> A resident of one of the Contracting States shall be exempt from tax by the other Contracting State of gains derived from the sale, exchange or disposition of capital assets…. [*Id.* at Article 14(2).]

In addition, tax treaties typically contain a clause on the relief from double taxation. In other words, if the United States imposes taxes on the same income that was subject to tax in the foreign jurisdiction, then a tax credit would generally be permitted to provide relief from double taxation. [*See United States Model Income Tax Convention*, Article 23.]

The following link provides a list of U.S. tax treaties that are currently in effect: *www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z.*

Administrative Hurdles

Significantly, though, tax treaty benefits are not always automatic. Indeed, many of the jurisdictions in Asia do not provide tax treaty benefits automatically 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 foreign investor is claiming entitlement under a tax treaty. Moreover, the investor must obtain a tax residency certificate from the tax authorities in the investor's home jurisdiction. In some countries, there are timing constraints too, with treaty benefits conceivably failing to apply because the foreign investor is not timely in making the requisite treaty benefits claims.

An investor can be at significant risk of being denied treaty benefits if any significant procedural matter is ignored. In addition, some jurisdictions have anti-tax avoidance rules that may give the tax authorities discretion to deny treaty benefits if the authorities 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 Acquisition/ Investment?

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

One main reason a Singapore or Hong Kong intermediary is used is that both jurisdictions offer tremendous tax benefits for offshore investments. For one, the receipt of foreign dividends by the investor generally does not trigger taxation (subject to certain conditions). Hong Kong notably provides that all foreign-source income will not be subject to tax. Another tax benefit is that neither Singapore nor Hong Kong has a capital gains tax regime.

There are operational tax advantages too. Corporate income tax rates in Singapore (17 percent) and Hong Kong (16.5 percent) 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 of the emerging Asian economies. Many of Singapore's tax treaties notably 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) would be allowed to impose capital gains tax on the transaction. This is notable because, as discussed above, Singapore does not impose any capital gains tax. [*See Convention Between the Government of the Republic of Singapore and the Royal Government of Thailand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to the Taxes on Income*, Article 13(3); *Agreement Between the Government of the Republic of Singapore and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, Article 13(6); *Agreement Between the Government of the Republic* *of Singapore and the Government of the Socialist Republic of Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income,* Article 13(5).]

Example: A U.S. investor uses a Singapore intermediary to invest in or acquire a company located in Vietnam. Under Vietnam's tax law, the payment of dividends by the Vietnamese entity to the Singapore intermediary would not be subject to withholding tax in Vietnam. In addition, the receipt of dividends by the Singapore intermediary would not be taxable in Singapore. Suppose that the investor divests itself from the investment, and the transaction results in a gain. Such gains are normally subject to the capital gains tax in Vietnam.

However, Article 13(5) of the Singapore–Vietnam tax treaty only permits Singapore to tax on the gains (as long as the Vietnamese company does not principally hold immovable property). As a result, Vietnam is not allowed to impose *any* tax on the sales transaction. As noted, Singapore does not have a capital gains tax regime.

Despite this impressive example, one should use caution in employing an intermediary company in Singapore, Hong Kong or any other foreign jurisdiction. One should consider the tax consequences under the U.S. controlled foreign corporation (CFC) rules. They would capture Subpart F income of the intermediary company.

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

Another word of caution is that both Singapore and Hong Kong adhere to the general anti-tax-avoidance stance and do not want to be seen as tax havens. In other words, the transaction and the entity would be required to have economic substance. One cannot employ a mere conduit or shell company in order to take advantage of tax treaty benefits. 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 its interest(s) in a foreign jurisdiction. 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. Thus, a foreign investor must be treated fairly and in the same manner as a domestic investor. Accordingly, Article 3 of the U.S. Model Bilateral Investment Treaty provides that:

(1) Each Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.

(2) Each Party shall accord to covered investments treatment no less favorable than that it accords, in like circumstances, to investments in its territory of its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

A BIT also includes a clause limiting expropriation by the foreign government. Article 6(1) of the U.S. Model Bilateral Investment Treaty provides that:

Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization ("expropriation"), except:

(a) for a public purpose;

(b) in a non-discriminatory manner;

(c) on payment of prompt, adequate, and effective compensation; and

(d) in accordance with due process of law and Article 5 … .

The United States has concluded a number of BITs with other jurisdictions. Curiously, though, very few are with Asian jurisdictions (a full list of BITs concluded by the U.S. can be found at *www.state.gov/e/eb/ifd/bit/117402.htm*). Thus, a U.S. investor that plans to invest directly into a region where no BIT has been concluded (*e.g.*, Southeast Asia) would not be guaranteed certain investment protection afforded under the BITs to which the United States is a signatory.

Intermediary BIT Shopping?

In certain cases, it may be beneficial to invest through another entity that is located 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). The ASEAN countries include Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

The ACIA is a type of BIT among the ASEAN countries to protect foreign investments in certain industries, such as manufacturing, agriculture, fishery, forestry, mining and quarrying, as well as other types of investments that the member states agree. [*ASEAN Comprehensive Investment Agreement*, Article 3.] The ACIA also includes clauses regarding national treatment [*Id.* at Article 5] and expropriation [*Id.* at Article 14], both 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.

Domestic Tax Considerations

There is much talk today of prevailing corporate tax rates. In order to attract more foreign investment, many of the 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, the U.S. or other foreign investor should not be focused solely on tax treaties and BITs. Understanding the domestic tax landscape could also prove beneficial to the investor. Different jurisdictions may have different tax incentives regimes that could be attractive to the investor.

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

There are changes occurring here too. In an effort to remain competitive and to lure foreign companies to set up their headquarters there, Thailand implemented a comprehensive ROH regime. 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. It provides tax incentives to companies using Malaysia as a base for conducting regional and global operations.

Another incentive that some jurisdictions offer is tax exemption for certain projects located in lesser-developed areas in the country. For example, Vietnam has moved to encourage investments in rural and economically disadvantaged areas. The government is empowered to provide attractive tax incentive benefits for investors into such regions for a stated length of time.

In Myanmar, economic development stalled for over six decades due to military dictatorship. However, the country has recently opened up to foreign investment. Myanmar now offers tax incentives for certain new investments that have been approved by the Myanmar Investment Commission. Cambodia may be an attractive alternative too.

Cambodia provides for tax incentives with respect projects that meet certain investment thresholds. Curiously, though, the tax incentives are not available for investments on a so-called negative list. If an otherwise-qualifying investment is covered by the proscribed "negative list," then the project would not be qualified for the tax incentives regime.

Good, Bad or Ugly?

In this section, we explore various tax incentives in the ASEAN region. The hopscotch can at times seem random, clearly showing the importance of understanding the local tax landscapes when investing into a foreign country. From a tax viewpoint, not all countries are created equal.

Moreover, some jurisdictions may have more international exposures than others. In addition, one jurisdiction may have specific incentives that are not available in neighboring countries.

Thailand

An ROH in Thailand is a type of corporate entity established for the purpose of providing managerial, administrative and technical support services to other affiliated companies operating in the region. The operations of an ROH are limited to the following activities:

a. organizing administration and managing business planning;
b. sourcing of raw materials, parts and finished products;
c. researching and developing activities;
d. providing technical support;
e. marketing and sales promotion;
f. regional human resources training and development;
g. business advisory services (such as financial management, marketing, accounting, etc.);
h. investment feasibility studies and economic and investment analysis; and
i. credit management and control.

The following incentives are offered to an ROH:

a. tax exemption on service income from related companies and branches of the ROH outside of Thailand for a period of 10 years;
b. tax exemption on dividend income received from all related companies and branches of the ROH for a period of 10 years;
c. withholding tax exemption on payment of dividends to any related companies outside of Thailand; and
d. 15-percent flat tax rate on salaries paid to expatriate employees in Thailand for a period of eight years, and tax exemption on salaries paid to expatriate employees outside of Thailand.

Certain requirements must be met in order to benefit from the above incentives. For example, the ROH would need to have an investment capital of at least 10 million baht (approximately $300,000). In addition, the ROH must provide its services to at least one affiliate during its first and second years of operation.

There are ongoing requirements too. During its third and fourth years of operation, the ROH is required to provide services to at least two affiliates. Thereafter, in the fifth and subsequent years of operation, the ROH is required to provide services to at least three affiliates.

Malaysia

Malaysia provides tax incentives for principal hub companies. A "principal hub company" is defined as a locally incorporated company that uses Malaysia as a base for conducting its regional and global businesses and operations. The company's main activities are to manage,

Table 1. Tax Incentives in Vietnam

Types of Income	Preferential Tax Rate	Tax Exemption	50% Tax Reduction
Income from new investment projects located in areas facing extreme difficulties in socio-economic conditions	10% for 15 years from the year of generating income	Four years from the first year of generation profit	Nine years following the tax exemption period
Income from new investment projects located in areas facing extreme difficulties in socio-economic conditions which engage in social sectors, such as education, vocational training, healthcare, culture, sports and environment	10% for the entire project	Four years from the first of generating profit	Nine years following the tax exemption period
Income from new investment projects located in areas facing difficult socio-economic conditions	20% from the year of generating income (to be reduced to 17% beginning 2016)	Two years from the first year of generating profit	Four years following the tax exemption period

control, and support its key functions, including management of risks, decision making, strategic business activities, trading, finance, management and human resource.

A company that has been approved by the Malaysian Investment Development Authority as a principal hub is eligible to a tax incentive rate at either 0 percent (tier 1), 5 percent (tier 2) or 10 percent (tier 3). The applicable rate depends on which tier the company falls under based on the following criteria: level of business spending, number of high-value jobs created, value added functions and number of countries served.

The tax incentive rate is applicable for a period of five years. However, this term may be extended for an additional five years if certain conditions regarding job commitment and business spending are satisfied. To be eligible for the principal hub tax incentive, the following conditions must be met:

a. Incorporation in Malaysia;
b. Paid-up capital of more than RM2.5 million (approximately US$700,000);
c. Minimum annual business spending of RM3 million (approximately US$850,000);
d. Minimum annual sales of RM300 million (approximately US$85 million) (additional requirement for goods-based applicant companies);
e. Serves and controls network companies in at least three countries outside of Malaysia;
f. Carry out at least three qualifying services, one of which must be related to strategic services (*i.e.*, planning and development, corporate advisory, brand and IP management, senior level talent management);
g. Significant use of Malaysia's banking and financial services and other ancillary services and facilities (*e.g.*, trade and logistics services, legal and arbitration services, finance and treasury services); and
h. Employment and business spending requirements based on the applicable tier.

Vietnam

The government in Vietnam encourages investors to fund projects that are located outside of major urban areas. There is a decided focus in stimulating the injection of capital and infrastructure into historically poor and rural areas. Certain tax incentives, including preferential income tax rates, tax exemption and tax reduction, are listed in Table 1.

Other incentives are also available for projects in certain industries. These include agriculture, livestock, manufacturing and the exploration of natural resources.

Myanmar

Myanmar is currently transitioning from a military dictatorship to a democracy. In an effort to encourage foreign investors, Myanmar passed the Foreign Investment Law in 2012. This law provides attractive incentives for foreign investors who receive approval from the Myanmar Investment Commission in connection with their projects.

Some of the tax benefits that a foreign investor may enjoy under the Foreign Investment Law include:

a. five-year exemption from corporate income tax;
b. 50-percent income tax reduction with respect to exports;
c. exemption from income tax for profits reinvested in Myanmar within one year;
d. import duty exemption on certain machinery, equipment, tools and parts during the construction period;
e. three-year import duty exemption on raw materials; and
f. commercial tax exemption on products manufactured for exports.

The importance of Myanmar's Foreign Investment Law of 2012 cannot be overstated. Since its passage, Myanmar has seen an unprecedented level of foreign direct investment. Its GDP growth continues to surpass GDP of many of its neighboring countries. Myanmar is being viewed as the darling of ASEAN from a foreign investment prospective.

Cambodia

Cambodia provides tax incentives for "qualified investment projects." In general, these are projects that reach a certain investment threshold (ranging from $200,000 to $2 million, depending on the type of project). But Cambodia excludes from these perks the types of projects listed on Cambodia's own negative list, which includes:

a. commercial activities (import, export, wholesale and retail);

b. transportation activities, except the railway sector;
c. restaurants and entertainment facilities;
d. tourism services;
e. casino and gaming activities;
f. financial services;
g. media;
h. professional services;
i. production of wood products;
j. complex resorts, such as hotels, theme parks and zoos;
k. hotel below three-star grade; and
l. real estate and warehouse facilities.

The tax incentives in Cambodia for a qualified investment project include income tax exemption for up to nine years and import duty exemption on certain machinery and equipment. Understandably, foreign investors may find this alluring.

Yet a notable point with respect to Cambodia is that due to nuances in the domestic tax law, payment of dividends by a qualified investment project would trigger taxation for the investor. Thus, careful tax planning is key to avoid this consequence. In addition, Cambodia has not concluded a tax treaty with any country.

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 changing legal environments, things can change.

Conclusion

Direct, indirect, wholly owned or fractional joint venture, 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 or even disastrous. Due to the nature of cross-border transactions and the investor's unfamiliarity with foreign tax laws, it goes without saying that an investor should consult savvy tax advisors, and wherever possible, make contingency and repatriation plans. Both the emerging economy and the foreign investor can emerge as winners.

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