Asia-Pacific International Tax Insight

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Asia-Pacific International Tax Insight

Asia-Pacific International Tax Insight is a timely periodical jointly prepared by Ernst & Young's International Tax Services and the Asia-Pacific Business Group ("APBG"). The APBG is comprised of multilingual Foreign Desks, based principally in New York, drawn from a regional pool of senior Ernst & Young professionals as part of our long standing foreign exchange program. The publication aims to provide a timely update and analysis on significant cross-border tax developments to multinationals investing in or operating in Asia-Pacific. The discussion and analysis is intended to serve as a guide to alert readers to current regional tax developments, opportunities, and emerging issues.

This edition focuses on the use of holding companies in tax planning and structuring in the Asia-Pacific region and discusses the growing attractiveness of using Hong Kong and/or Singapore as a regional holding company.

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In this issue

Overview*

When investing into Asia-Pacific significant structuring aspects should be considered. These include local country withholding taxes, access to double tax treaties, capital gains tax, transfer taxes, thin capitalization rules, deductibility of expenses, the availability of tax holidays or reduced tax rates, permanent establishment and/or tax residency, as well as transfer pricing considerations, and more recently general anti-abuse rules (GAAR) and other anti-treaty shopping measures, which are becoming an increasingly important consideration. Further, a multinational enterprise (MNE) will need to consider how Asia-Pacific fits into their overall investment strategy, operational and/or tax and legal structure as well as their existing tax strategy.

The overall investment structure must consider the various countries in which the MNE is investing in, or operating in, as well as where the business has located its Asia-Pacific regional management, operational activities, including manufacturing, research and development, finance, legal and sales and marketing functions, and how such operations are structured.

Therefore, a MNE investing into Asia-Pacific is typically faced with a number of important business, legal, and tax considerations and decisions, when assessing and developing an efficient legal entity structure, capital structure, intellectual property ownership structure (if applicable), and operational model, as these issues do not exist in a vacuum.

Invariably, an important aspect of the structuring will entail how the use of a holding company, or holding company structure, may facilitate making the investment, or acquisition, more tax efficient. This discussion focuses on the use of holding companies in tax planning and structuring in the Asia-Pacific region and discusses the growing attractiveness of using Hong Kong and/or Singapore as a regional holding company.

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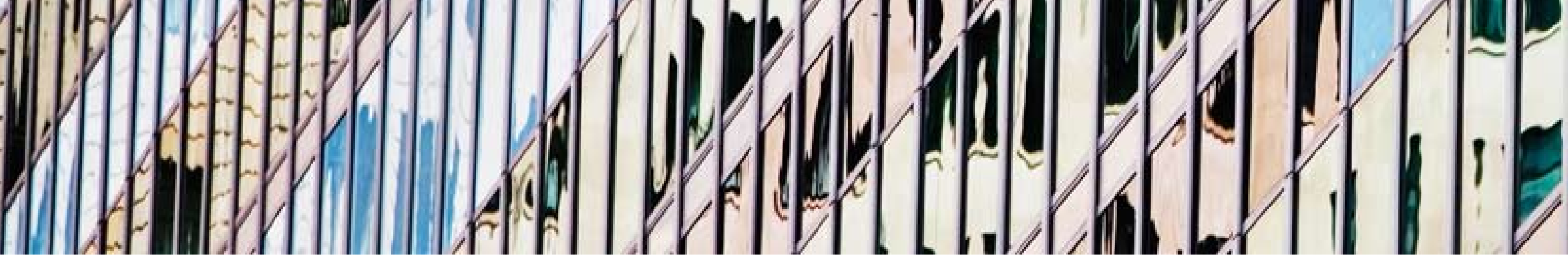


Use of holding companies

The use of holding companies in structuring and international tax planning, e.g., to reduce dividend withholding taxes, and/or reduce or eliminate investee country taxation of capital gains upon an exit are well established. In addition to often being essential to efficient structuring in general, a holding company structure, together with various tax planning techniques, can also be an important aspect of more comprehensive tax planning employed by an MNE and is often integral to a company's global tax strategy. A holding company structure often involves the holding of multiple investments or participations, and may combine holding activities with financing and/or treasury management activities, and may comprise multiple tiers of holding companies located in one or more jurisdictions. Alternatively, it may entail establishing a mere conduit entity or a special purpose vehicle (SPV) for a more limited purpose, e.g., for holding a single investment.

With an increasing amount of investment in the region and the continued use of multi-tiered investment structures to minimize or avoid local country taxes, tax authorities in many of the Asia-Pacific jurisdictions are closely scrutinizing conduit entities and SPVs that lack commercial substance and may have been established for the purpose of achieving tax benefits, including treaty shopping. As such, MNEs should be aware that business purpose and commercial substance are becoming increasingly important in achieving intended tax benefits.

There are many business driven motives for establishing a holding company structure. To a MNE, a holding company can provide a means to own and manage a group of affiliates or subsidiaries in a particular region, such as Asia-Pacific. This can result in operational and financial efficiencies, in particular when bundled with other business functions, including broader regional headquarter and management functions, group shared services, financing, cash management, and/or intellectual property ownership and management.

As discussed, such business reasons are becoming increasingly important to consider when selecting a holding company location given the opportunities to combine other business functions with the holding company function. With the increasing focus on beneficial ownership, indirect share transfers, and tax motivated transactions, many of which the tax benefits are increasingly being conditioned on demonstrating the commercial rational or business purpose of entities and/or transactions, and may be subject to the satisfaction of varying substance requirements, e.g., when using a holding company to reduce dividend withholding tax, this should be a key consideration.

Selection of the holding company location

The holding company location or jurisdiction should allow for a broad range of activities which should include the holding of investments (including shareholdings or participations in group companies), financing/granting of loans, treasury and cash management, including cash pooling/netting and centralizing group-wide currency risks, ownership and exploitation of intangibles, and increasingly should allow other business activities, e.g., trading and other operations.

The location of the holding company should be sound in standing in the international business community, politically and economically stable, "tried and tested" as a holding company location, efficient from a tax and treasury perspective, efficient from a corporate law perspective, attractive in terms of geographic location and proximity to the MNE's business operations, have low establishment and operating costs, minimal or manageable accounting, and reporting and disclosure requirements, and availability of well-qualified and trained workforce at competitive salaries. The primary tax considerations for determining an appropriate holding company location include the minimization of direct taxes (e.g., corporate income tax), minimization of indirect taxes (e.g., capital duty, stamp duty or transfer taxes), access to tax treaties and the reduction or elimination of withholding taxes (outbound and inbound) and capital gain taxation.

If the holding company is intended to be the location of the MNE's regional headquarters, then the following are also typically considered when choosing the location of the holding company (this list is not all-inclusive):

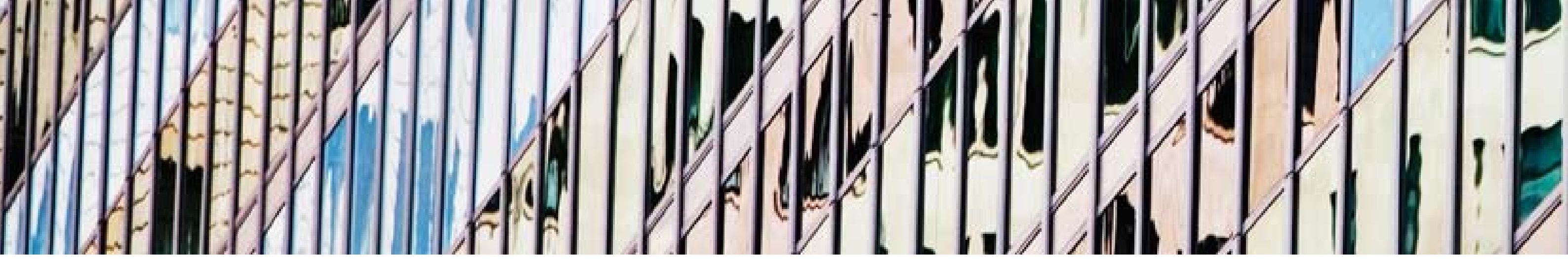
- location of current regional management
- location of significant regional operations
- countries in which the organization operates
- proximity of airports and ease of access
- language barriers (e.g., is English a commonly spoken language?)
- availability of required visas and/ or work permits, if required
- cost of living
- desirability of the location in terms of standard of living and
- individual income tax rates and taxation of expatriates.

In this context, it should be noted that Singapore took top spot in the World Bank's "Doing Business" 2011 report, beating 183 economies including the larger nations like the United Kingdom and United States to be the easiest country to do business in. This was Singapore's 5th consecutive year as leader of the charts since 2007. Nine criteria were used in the assessment, amongst which were the ease of starting and closing a business, getting credit and trading across borders.

Selection of an Asia-Pacific holding structure

In general, selecting the optimal holding company for investments or participations in the Asia-Pacific region often proves to be a greater challenge than in Europe. When analyzing the preferred holding company location for Europe, the analysis tends to focus primarily on the attributes of the jurisdiction of the holding company location. Outside of the specific application of the European Community (EC) Directives[1] and analysis of

[1] EC Directives lay down certain end results that must be achieved in every European Union Member State. Directives are used to bring different national laws into line with each other. For example, Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States was designed to eliminate tax obstacles in the area of profit distributions between groups of companies in the EU by abolishing withholding taxes on payments of dividends between associated companies of different Member States and preventing double taxation of parent companies on the profits of their subsidiaries. The amending Directive 2003/123/EC was adopted to broaden the scope and improve the operation of the "parent-subsidiary" and contained three main elements: updating the list of companies that the Directive covers; relaxing the conditions for exempting dividends from withholding tax (reduction of the participation threshold); and eliminating double taxation for subsidiaries of subsidiary companies.



relevant tax treaties, and/or local anti-abuse legislation, less of the analyses tend to focus on the attributes and laws of the jurisdictions of each of the underlying participations, in particular if the participations are within the European Union (EU).

Unlike the EU, the Asia-Pacific region does not have systematic and coordinated arrangements, for example, EC-like directives governing inter-country treatment of withholding taxes on payments made to another country in the region or the taxation of income related to distributions received from another country in the region. The preferred holding company location for Asia-Pacific holdings is therefore dependent not only on numerous tax and non-tax factors in regard to the holding company location but also on attributes of the subsidiary locations. Thus, even more than for Europe, the best holding company location must be analysed on a case-by-case basis taking into account the domestic law and treaty networks of the subsidiary company locations given the diverse political landscape, and varying legal systems and tax laws throughout Asia. There is no common pattern to follow for jurisdictions in Asia-Pacific because each jurisdiction conducts their business in vastly different ways. That being said, certain themes are evident like the increasing need for business purpose and commercial rational for setting up an intermediate holding company given the increasing scrutiny by certain countries.

From an analytical perspective it is often useful to approach the analysis by bifurcating the Asia-Pacific jurisdictions into at least two categories, i.e., (i) countries that do not levy a dividend withholding tax or tax non-resident shareholders on capital gains related to the disposal of shares, and (ii) countries that levy a dividend withholding tax and/or tax non-resident shareholders on capital gains related to the disposal of shares. The former group includes Hong Kong, Malaysia and Singapore while the latter group includes Australia, mainland China, India, Indonesia, Japan, Thailand, New Zealand, Philippines, South Korea, Taiwan and Vietnam[2].

Selection of the holding company location for Hong Kong, Malaysia and Singapore tends to focus on the attributes of the holding company location given those jurisdictions do not levy a dividend withholding tax or tax non-residents on capital gains. In many instances the use of traditional tax havens for holding these participations may be the preferred approach (provided the use of a haven does not cause issues under the tax laws of the parent jurisdiction) or utilizing a tax efficient holding company jurisdiction. More careful consideration is required in terms of determining the ideal holding company location for holdings in those latter countries and assessing the availability of tax treaty benefits or the effectiveness of other planning. As discussed, holding structures are being increasingly scrutinized by certain countries and therefore many MNEs are avoiding or limiting the use of traditional tax havens as well as treaty-based SPVs which preclude or make impractical the ability to build adequate operational substance in such locations or entities.

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[2] In general, Australia does not levy a dividend withholding tax on dividend distributions provided the underlying earnings are franked. Further, Australia does not tax non-residents on capital gains resulting from the alienation of shares provided the shares are not in a land rich company or group. New Zealand and Taiwan do not tax non-residents on capital gains. Vietnam does not levy a dividend withholding tax but does tax capital gains of non-resident shareholders. India does not levy a dividend withholding tax.

While few jurisdictions within Asia-Pacific have adopted tax policies and put in place tax legislation that specifically encourages and promotes their country as a holding company location, certain locations are quite attractive. Common regional holding company locations are Singapore, and more recently, Hong Kong, particularly when holding activities are coupled with substantive operations in those jurisdictions and/or the holding activities are related to (and eligible for) beneficial treatment under a special tax regime (e.g., Singapore's Regional Headquarters regime or International Headquarters). As discussed, Hong Kong is becoming an increasingly attractive location and therefore we provide a side-by-side comparison with Singapore which tends to be the more commonly used location to establish a regional holding company in Asia-Pacific.

Other locations that may be used include Labuan (a Malaysian territory) or Mauritius, e.g., to hold investments in mainland China and/or India, and in some cases, Australia, e.g., in connection with a debt push-down strategy or alternatively a European holding company, e.g., the Netherlands, in particular when an existing global structure can be leveraged into Asia-Pacific.

A word of caution

Tax benefits are increasingly being conditioned on demonstrating the commercial rational or business purpose of transactions and/or the satisfaction of varying substance requirements. Where substance is required, the nature of the substance varies and is evolving (e.g., economic versus physical substance). Substance requirements are being established by local tax authorities as preconditions to obtaining tax treaty benefits or other tax benefits and should be considered. There is an increasing focus on the use of GAAR attacks within Asia-Pacific and local authorities are relying more on substance-over-form and step transaction principles.

Certain jurisdictions, e.g., mainland China, India, Indonesia, Japan and South Korea, are increasingly aggressive in denying tax treaty benefits and/or making substance-over-form attacks. Business purpose, tax residency, beneficial ownership, substance and operational alignment are becoming increasingly important and we are finding that tax benefits are increasingly being conditioned on the satisfaction of varying business purpose and substance requirements.

This analysis focuses on Hong Kong and Singapore, both of which lend themselves to building operational substance in the holding company location and are attractive holding company jurisdictions. With a closer scrutiny on beneficial ownership and claims for reduced withholding taxes and the increasing use of general anti-avoidance and substance-over-form attacks, MNEs are well advised to establish operational substance in their holding company structures to be able to withstand potential challenges by tax authorities in the region.

The use of Hong Kong and Singapore - a comparative analysis

As with making any new investment, an MNE investing into the Asia-Pacific region faces numerous business, legal and tax structuring issues when developing an efficient structure and operational model. In particular for investments into this region, the overall investment structure should also take into consideration the various local jurisdiction peculiarities such as business culture, political stability and even religious undertones when structuring its management and operational activities.

Hong Kong and Singapore are discussed below vis-a-vis some common features of holding companies. While there are similarities in the features of Hong Kong and Singapore, which make them both attractive holding company locations, there are distinct features of each that should be noted, and tax and non-tax factors will make the ultimate choice fact specific.

Statutory tax rates

Hong Kong has a flat corporate rate of profits tax of 16.5% which applies to profits arising in or derived from Hong Kong under its territorial tax system. Under the territorial basis of taxation, foreign-source income is exempt from Hong Kong profits tax. Taxable income or "assessable profits" essentially includes all Hong Kong-sourced income from a trade or business carried on in Hong Kong, such as sales revenue, royalties, rental, interest, fees and commissions.

Singapore has a corporate income tax rate of 17%, with a partial exemption for the first SGD300,000 of normal chargeable income, resulting in an effective tax rate of 8.36% for this first SGD300,000. The rate applies to income sourced in Singapore and on income from sources outside Singapore if received in Singapore.

Tax incentives

Hong Kong grants tax incentives only to a few industries or investment activities, e.g., the tax exemption granted to non-resident funds operating in Hong Kong under certain conditions, and a lower tax rate for income earned from the business of reinsurance of offshore risks and from certain qualifying debt instruments.

Singapore grants investment incentives for certain activities. The incentives are available to a number of industries and include manufacturing, services, trading, entrepreneurial investment and finance. They are usually in the form of grants, enhanced deductions, or exemption from tax, or reduction in tax rate. While there are no specific incentives for holding companies, the broad range of incentives make Singapore an attractive place to do business and generally require business activities that can support the desired substance in a regional holding company.

Taxation of trading income

Trading income is generally taxed at the statutory tax rates. Local tax incentives or jurisdictional planning ideas in certain jurisdictions may be available to reduce the effective rate of tax on trading income. In some instances, an advance tax agreement can be obtained which provides for certain tax incentives or taxable base reductions. In general, both Hong Kong and Singapore will tax trading income at their respective statutory tax rates of 16.5% and 17%. However, as mentioned above, Singapore offers a broad range of incentives and in some case a tax exemption that will provide for a 0% tax rate.

Hong Kong has a territorial system and taxes profits arising or derived in Hong Kong. The determination of the source of profits or income can be complicated and often involves uncertainty. This creates both opportunities and risks that should be considered. Taxpayers may apply to the Hong Kong Inland Revenue Department for advance tax rulings to address potential uncertainties and seek confirmation regarding the proper tax treatment.

In Singapore, income tax is imposed on all income deriving from sources in Singapore, and on income from sources outside of Singapore if received in Singapore. Further, given Singapore offers a wide range of tax incentives and grants, a Singapore holding company with an operational set-up may be awarded Singapore tax incentives and grants, which are given on a case by case basis upon application. If properly structured, this could result in significant tax optimization for MNEs. Sometimes, peripheral advantages also arise from being awarded tax incentives. For example, by centralizing the group's regional or global trading activities in Singapore, the company may qualify for a reduced corporate tax rate under the Global Trader Program or the International Headquarters award. This offers potential advantages for MNEs whose parents are located in countries with controlled foreign corporation (CFC) regimes or proposed CFC regimes (e.g., India) that provide safe harbor provisions for such activities.

As tax authorities around the Asia-Pacific region increase in jurisprudence, there is a strong need for tax structures to be based on sound economics and commercial rationale rather than predominantly tax driven. Therefore, conducting regional operations or performing treasury functions in the Singapore holding entity will often prove to be a preferred option than the traditional notion of setting up a pure holding company with little or no employees or operations. With the business operations based in Singapore this can give the holding entity a level of commercial substance. Similarly, MNEs with operational substance in Hong Kong can benefit from that substance and we are seeing MNEs leveraging that substance in their Hong Kong holding company structures, e.g., by moving employees and business functions into the Hong Kong holding company.

Taxation of dividends

A common and very important feature of the most popular holding company locations within Europe is the existence of a "participation exemption" regime, which generally provides that dividends from qualifying participations are exempt from taxation. In most instances the exemption provides for 100% relief (in other cases a 95% exemption is available) subject to meeting certain conditions. In general, few jurisdictions in Asia-Pacific have a participation exemption regime. Exceptions include Australia, Japan and Singapore.

In Hong Kong, dividends are generally not subject to profits tax and are exempt from tax in the hands of the recipient.[3]

Remittances of specified foreign income into Singapore are exempt from tax if prescribed conditions are met. One of these specified foreign-sourced income is dividend income. Foreign-sourced dividend income received directly in Singapore by persons who are tax resident in Singapore will be tax exempt in Singapore, subject to satisfaction of certain conditions, including a "subject to tax" test (i.e. the income is subject to tax in the territory from which the income is received) and that the highest tax rate of foreign jurisdiction from which the income is received is at least 15%. In cases where conditions for the foreign-sourced income exemption regime cannot be met, foreign tax credits (including unilateral tax credits), may be claimed. The Singapore government has also introduced a foreign tax credit pooling system, subject to meeting specified conditions, should give companies greater flexibility in using foreign tax credits, reduce and simplify the taxation of foreign income, and better encourage remittances to Singapore. The new foreign tax credit pooling system will take effect from the year of assessment 2012.

Capital gains and losses

In both Hong Kong and Singapore, gains derived that are of a capital nature will not be taxed. The converse holds true for capital losses. These are not deductible for tax purposes. It should be noted, that while Hong Kong and Singapore do not tax capital gains, gains on disposals of shares may be subject to income tax if the gains are considered income in nature. While, in general, this is more of a relevant consideration in Singapore than in Hong Kong, in both cases care should be taken in planning disposals.

Taxation of financing and royalty income

Interest and royalty income is usually taxed in a manner similar to trading profits at normal corporate statutory tax rates even in the most favorable holding company jurisdictions. Thus, in many cases using the holding company directly for financing or licensing may be tax inefficient. In limited cases, a special regime or structure may be available that effectively reduces the rate of tax.

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[3] It should be noted that the IRD is of the view that certain Hong Kong sourced dividends are technically chargeable to tax in Hong Kong – see Item A1 (I) of the minutes of the 2011 annual meeting between the CIR and HKICPA.

In general, interest and royalty income is taxable in Hong Kong if it is sourced in Hong Kong. There are limited exemptions for certain interest income but this would not include cross-border financing income that is Hong Kong-sourced. With proper planning and care, Hong Kong can be used for financing without incurring Hong Kong profits tax.

One potentially attractive incentive in Singapore is the finance and treasury centre incentive. The finance and treasury centre incentive is aimed at promoting companies to use Singapore as a base for conducting treasury management activities for related companies in the region. Subject to conditions, a reduced rate or other concessionary rate is available for a period up to 10 years on income from qualifying activities. In addition to the reduced rate of tax, outgoing interest payments are exempt from withholding taxes if the funds raised are used for carrying out qualifying finance and treasury activities. As discussed further below, consideration should be given to inbound withholding taxes, and the ability to reduce interest withholding tax under any applicable tax treaty, as well as the ability to claim a foreign tax credit on such taxes in Singapore.

Deduction of interest costs

The rules dealing with the deductibility of interest expense incurred in connection with the acquisition of equity participations vary widely across jurisdictions. In some instances, interest on a loan incurred to purchase shareholdings is not deductible, or is only deductible if the interest exceeds any tax-exempt dividends and capital gains income earned by the company during the year. In other cases, the interest expense can be used to offset operating profits of group companies, subject to specific requirements, or is deductible subject to detailed anti-avoidance rules. Some jurisdictions also have so-called "thin capitalization" rules that generally disallow interest deduction when specified debt-to-equity ratios are exceeded.

Hong Kong does not have thin capitalization rules. However, Hong Kong has put restrictions on the deductibility of interest to combat avoidance and disallows interest expense deductions unless the interest expense is incurred in the production of chargeable profits in Hong Kong and one of six other conditions is met. Interest expense on the acquisition of shares which are held for long-term investment purposes is not deductible given expenses that are not incurred for the purpose of producing assessable profits are not tax deductible.

Similarly, in Singapore, interest expenses are tax deductible so long as the expenses are incurred on money borrowed for the purpose of acquiring income and are not specifically disallowed in the Singapore income tax legislation. With respect to interest expenses incurred on acquisition of shares, because the income derived from these participations are generally tax exempted under the foreign-sourced income regime discussed earlier, this would render void the deduction value of the interest expense. Interest expenses are tax deductible in other cases under the same general principals. Singapore does not have thin capitalization rules.

Withholding taxes

There are no withholding taxes in Hong Kong on dividends, interest or on other source income, whether paid to residents or non-residents. However, there is an effective withholding tax on royalty payments. Where the recipient of the royalty is not otherwise subject to Hong Kong profits tax, a deemed profit of 30% of the royalty is currently subject to profits tax. The deemed profit rate would however be increased to 100% for certain perceived tax avoidance arrangements. Given the current profits tax rate is 16.5% that works out to an effective withholding tax rate of 4.95% where the arrangements are not caught by the specific anti-tax avoidance provision.

Singapore does not levy a dividend withholding tax. Thus, with Singapore for example, foreign-sourced dividend income is generally tax exempt when received in Singapore if prescribed conditions are met and there is no dividend withholding tax in Singapore on outbound distributions. Therefore, dividends received in Singapore, say from operating Asia-Pacific companies, may be on paid free of Singapore tax to shareholders. Dividends paid out of profits of the Singapore company are also on paid free of Singapore tax to shareholders. This would also be the case with Hong Kong. Singapore does have statutory withholding taxes on interest and royalties of 15% and 10% respectively unless exempted or reduced under the tax legislation or the terms of a tax treaty.

In regard to inbound payments, certain jurisdictions do not levy a withholding tax on dividends, interest and/or royalties, regardless of the country of residence of the recipient. However, in most instances this is not the case and therefore the use of tax treaties is important to eliminate or reduce withholding taxes on inbound flows. In many instances, tax treaties eliminate or reduce dividend withholding taxes to 0%, 5% or 10%. Interest and royalty withholding taxes are most often reduced to 10%.

Treaty network

With more than 60 comprehensive tax treaties in place, the use of tax treaties to enjoy preferential tax treatment is common practice amongst MNEs with Singapore operations. Most of the treaties do not allow for the use of specific or general anti avoidance provisions. For example, the Singapore-India tax treaty accords taxing rights of capital gains arising in India, to Singapore (where gains of a capital nature are not taxable), so long as the limitation of benefits (LOB) clause in the tax treaty is met. This provides good treaty protection from Indian capital gains tax should there be a future exit scenario.

Another important consideration is the rate of withholding taxes applied at source on incoming dividends, interest and royalty flows. These withholding taxes may be eliminated or reduced under an applicable tax treaty. To be entitled to the reduced treaty rate of withholding tax, the beneficial owner must be tax resident in the other treaty country or jurisdiction[4]. Singapore's tax treaties generally require the recipient to be the beneficial

[4] If a resident of a treaty jurisdiction e.g., Singapore or Hong Kong receives passive income in the capacity of an agent or nominee it should be clear the entity is not the beneficial owner. The recipient is the beneficial owner if it has the full right to use and enjoy the income. This view is reiterated in the OECD's recent discussion draft dated 29 April 2011 regarding articles 10, 11, and 12 and the meaning of beneficial owner in the OECD Model Tax Convention.

owner of the income and often include a LOB clause. In regards to tax residency, it is worth noting that recently the Inland Revenue Authority of Singapore is increasingly scrutinizing requests for Singapore tax residency certificates in an attempt to prevent treaty abuse.

The recent proliferation of Hong Kong's tax treaty network is a positive development, albeit Hong Kong is in catch up mode in comparison to Singapore. The recent Hong Kong-Indonesia tax treaty (not yet ratified) includes for example more attractive provisions than the Singapore-Indonesia tax treaty on dividends, interest, and royalties.

In December 2003, Hong Kong entered into its first tax treaty (outside of its limited arrangement with mainland China entered into in 1998) with Belgium[5]. While Hong Kong is still in the early stages of expanding its network of tax treaties, under a backdrop of political pressure, Hong Kong has now quadrupled the number of tax treaties it has concluded since 2010. In 2009 and early 2010 Hong Kong was facing increasing international pressures for adopting the latest international standards for exchange of information.[6] As a result, in 2010 Hong Kong passed legislation which enabled the Inland Revenue Ordinance to be amended to enable Hong Kong to adopt the internationally agreed 2004 OECD standard for exchange of information. As a result of the change in law and subsequent adoption of the latest standard, Hong Kong has been actively negotiating tax treaties and is rapidly expanding its treaty network.

Prior to the law change in 2010, Hong Kong had concluded only 5 tax treaties[7]. Since the law change in 2010 Hong Kong has signed an additional 16 tax treaties. As at August 2011, Hong Kong has signed 21 tax treaties, including tax treaties or agreements with a number of significant jurisdictions.[8] A further 14 treaties are under negotiation.[9]

To date, Hong Kong has been used most extensively in connection with inbound and outbound investment into mainland China. The vast majority of inbound and outbound investments in 2010 occurred through Hong Kong (based on publically available statistics from mainland China's Ministry of Commerce). This is attributable to the favorable tax agreement and close connection between Hong Kong and mainland China, and the fact that it is becoming increasingly important to be able to move substance (i.e., people, assets, and operations) into the holding company location.

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5 Both Hong Kong and mainland China tax authorities take the view that mainland tax treaties with other countries do not cover Hong Kong.

6 During the London Summit of the G20 leaders which was held 2 April 2009, the G20 leaders called on countries to adopt the international standard for exchange of information. Following the Summit, the OECD published a progress report on 86 jurisdictions surveyed by the OECD Global Forum in implementing the standard and classified the jurisdictions as 1) white list, 2) grey list, or 3) blacklist. White list countries were jurisdictions that had substantially implemented, grey list had not but were committed, and black list jurisdictions had not even committed. While Hong Kong was not on the list, the OECD pointed out the list excluded the SARs (i.e., Hong Kong and Macao) which had committed to implement the standard.

7 In chronological order the tax treaties previously signed and entered into force were Belgium, Thailand, mainland China, Luxembourg, and Vietnam. On 21 August 2006 the governments of mainland China and Hong Kong replaced the limited scope arrangement entered into in 1998.

8 Hong Kong has concluded additional tax treaties which have entered into force with Austria, Brunei, Hungary, Ireland, Japan, Liechtenstein, and United Kingdom. Treaties pending ratification include, the Czech Republic, France, Indonesia, Kuwait, Netherlands, New Zealand, Portugal, Spain, and Switzerland.

9 Treaties under negotiation include Bangladesh, Canada, Denmark, Finland, India, Italy, Korea, Macau SAR, Malaysia, Malta, Mexico, Pakistan, Saudi Arabia, and United Arab Emirates.

With respect to inbound investment into Europe, Hong Kong provides a favorable route. The dividend withholding tax rate is zero under Hong Kong's tax treaties with Austria, Belgium, Ireland, Luxembourg, the Netherlands, Spain and Switzerland, which makes cash extraction out from Europe very tax efficient.

Given the proliferation of tax treaties enabling a 0% rate of withholding tax on dividends, and in many cases capital gains protection, Hong Kong is becoming an attractive holding company jurisdiction. While the specifics of each tax treaty should be reviewed, of the 21 tax treaties it is worth noting that 10 provide for 0% dividend withholding and 8 provide for a reduced 5% rate. In addition, all of the treaties provide capital gains tax protection[10]. Thus, often an important advantage with using Hong Kong is a 0% or reduced 5%, dividend withholding tax rate and a favorable capital gains tax article that allocates taxing rights to Hong Kong. Given Hong Kong does not tax capital gains very often an exit can be accomplished tax free (subject to the MNE's home country rules, e.g., CFC rules).

One potential disadvantage with Hong Kong tax treaties is that they often contain a specific or general anti-abuse clause which provides the treaty partner the right to impose their domestic law, including GAAR or anti-treaty shopping rules in assessing treaty shopping cases. Such clauses tend to be less prescriptive, and more subjective, than the LOB clauses found, for example in most United States treaties.

The presence of a Mutual Agreement Procedure provision in tax treaties also provides a degree of assurance to taxpayers that there is a mechanism by which the respective tax authorities may enter into discussion, should income not be taxed in accordance with the respective tax treaty. This includes transfer pricing matters and provides an avenue for advance pricing arrangements to be concluded.

Once again, consideration should be given to specific requirements of the relevant tax treaty and anti-abuse legislation and/or LOB articles must be analyzed. Tax benefits are increasingly being conditioned on demonstrating the commercial rational or business purpose of transactions and/or the satisfaction of varying substance requirements. Local authorities are relying more on substance-over-form and step transaction principles. Where substance is required, the nature of the substance varies and is evolving (e.g., economic versus physical substance). An analysis of the relevant tax treaties and conditions for their application, e.g., LOB articles, is required along with an analysis of local country treaty overrides, application of GAAR or other challenges from tax authorities. Certain jurisdictions, e.g., mainland China, India, Indonesia, Japan and South Korea are increasingly aggressive in denying tax treaty benefits and/or making substance-over-form attacks.

[10] Mainland China and France require less than 25% ownership and the tax treaty with Vietnam requires less than 15% ownership.

Capital duty or other taxes

Both Hong Kong and Singapore, other than a minor stamp duty, do not levy any significant capital duties or other taxes that affect holding companies. For instance, Hong Kong has a capital duty of only 0.1% on share capital but the amount is capped at HKD30,000 per transaction which is not a significant amount in the context of most investments. Hong Kong and Singapore both have a 0.2% stamp duty on the sale and purchase of shares.

Tax consolidation

Consolidated filings are not permitted in Hong Kong nor are group relief for losses. Singapore has group relief measures under which current year unutilised losses, capital allowances, and approved donations may be transferred from one company to another within the group, subject to meeting certain qualifying conditions.

Anti-avoidance, CFC and transfer pricing rules

In Hong Kong, transactions that are artificial, fictitious, or predominantly tax-driven may be disregarded or reconstructed by the tax authorities under general anti-avoidance measures. Singapore's tax legislation allows the Inland Revenue Authority of Singapore to disregard or varying any arrangement that has the purpose or effect of altering the incidence of taxation or reducing or avoiding Singapore tax.

Hong Kong and Singapore do not have CFC rules.

Hong Kong law does not contain comprehensive transfer pricing rules. The Hong Kong Inland Revenue Department issued DIPN 46 in December 2009 setting out its views on transfer pricing guidelines and methodologies and the practice is evolving.

Singapore has specific legislation governing the arm's length principle to be applied to related party transactions. The Inland Revenue Authority of Singapore may make adjustments to profits for income tax purposes in cases where the terms of commercial or financial relations between two related parties are not at arm's length. Singapore also released transfer pricing guidelines with detailed guidance on transfer pricing, including documentation and advance pricing agreements. Singapore transfer pricing guidance closely parallels the OECD transfer pricing principles.

Foreign exchange controls

There are no foreign exchange controls on inbound or outbound fund transfers in Hong Kong or Singapore.

Individual income tax rates

Another important consideration is individual tax rates. The individual tax rates in Singapore range from 0% for the first SGD20,000 of chargeable income to 20% for chargeable income exceeding SGD320,000.

Hong Kong also has a low individual income tax regime, with low graduating rates and a standard maximum rate of 15%.

This makes both Hong Kong and Singapore attractive locations in terms of individual taxation and positively impacts the ability to attract and retain the necessary workforce.

Concluding remarks

Recent developments have forced MNEs to look more closely at their structures and have increased the need to better align tax strategy, planning with corporate strategy and operations. In other words it is increasingly important to build substance in the holding company location.

There are many factors to be taken into account in determining where an Asia-Pacific holding company should be located. The choice of holding company jurisdiction and structure depends not only on tax factors, but often non-tax quantitative factors as well as non-quantitative factors, including personal experience, preference, business purpose and alignment with business operations (e.g., substance). Both Hong Kong and Singapore lend themselves to building up operational substance within the region, which is increasing the use of each of these jurisdictions as regional holding company locations.

In relation to tax efficiency it is often constructive to prepare a side-by-side analysis of the jurisdictions under consideration (see Table 1 below). However, an Asia-Pacific holding company location that provides the optimal location or foundation (balancing tax and non-tax factors) for building a global tax and legal structure for a particular MNE will be dependent on the location of the parent company, the goals and objectives of the MNE, and the particular facts and circumstances of each specific case.

As discussed in this article both Hong Kong and Singapore are quite attractive locations for establishing a holding company within Asia-Pacific and can play an integral part of an MNE's tax strategy as well as their regional operational and supply chain structure, with each location offering certain advantages and at the same time special considerations.

Table 1 – Comparative Summary of Hong Kong, Singapore and a Tax Haven

Item	Hong Kong	Singapore	Tax Haven (e.g., British Virgin Island)
Tax treaty network	Developing – 21 treaties	Extensive – 60 plus treaties	None
Practicality of adding substance (low, medium, high)	High – common location for Asia-Pacific operations	High – common location for Asia-Pacific operations	Low
Dividend withholding tax (statutory rate)	None	None	None
Dividend withholding tax on outbound payments to the holding company	Statutory rate or lower treaty rate on outbound payments (to Hong Kong)	Statutory rate or lower treaty rate on outbound payments (to Singapore)	Statutory rate
Dividends and capital gains treatment in holding company location	Capital gains and dividends are not taxable in Hong Kong	Capital gains are not taxable in Singapore. Dividend income remitted to Singapore tax exempt, subject to conditions being met	Capital gains and dividends are not taxable in the tax haven location
Capital gains protection in divestee country	Statutory rate but protected under most of the recent treaties	Statutory rate but protected under a number of treaties	Statutory rate
Interest income	No Hong Kong income tax on interest that is not sourced to Hong Kong	No Singapore tax if not sourced in, or foreign interest income not remitted to Singapore. 17% (10% if qualify for Finance and Treasury Center Incentive) for local sourced or remitted interest to Singapore	Non-taxable
Statutory rate of withholding tax on outbound interest payments	None	15% but incentives and planning may be available to mitigate.	None
Royalty income	No Hong Kong income tax on royalty income that is not sourced to Hong Kong	17% on taxable income, but incentives and planning may be available to mitigate. No Singapore tax if not sourced in, or foreign royalty income not remitted to Singapore	Non-taxable
Statutory rate of withholding tax on outbound royalty payments	4.95% effective rate (increased to 16.5% where the specific anti-tax avoidance provision applies).	10%. Incentives may be available to reduce the rate to 0% in certain instances	None
Stamp duty on transfer of shares	Stamp duty of 0.2% on the greater of the fair market value or the consideration	Stamp duty at 0.2% on the greater of the fair market value or the consideration	None

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