How you should structure investment in China and SE Asia

China and South-East Asia offers investors a wide range of potential business locations. In the first of two articles, Steven Herring of RSM International examines the tax issues when investing in China, Hong Kong, Indonesia and the Philippines

China's accession to the WTO in 2001 has had a significant impact on Chinese foreign trade and investment policies. The removal of tariff barriers and relaxation of many of the restrictions over foreign investment have unleashed significant opportunities and challenges for both current players and newcomers.

China offers various incentives such as income tax holidays and reduced tax rates to attract foreign investment. These incentives are focused on key industries and economic zones for which imported advanced technology and know-how are needed to help modernize the Chinese economy.

Mergers and acquisitions are one of the quickest ways for new and existing foreign investors to expand their market share in post-WTO China.

Structuring a share deal

Typically, a foreign investor will acquire the equity of a Chinese target company from the seller (direct acquisition), or will acquire the shares of a foreign company holding a Chinese target company (indirect acquisition).

A target company in China will remain as a going concern subject to any conditions granted by the relevant authorities when the target was set up. As there is no change to the legal form of the acquired entity and no disruption to its tax attributes, a target company cannot re-value its asset base for Chinese tax purposes.

Under a typical share deal model, a buyer would use an offshore investment holding vehicle to acquire a Chinese target company . This is largely because foreign companies other than major multinationals cannot easily establish special purpose holding companies in China. The countries, which are commonly used to set up offshore-holding vehicles, include Hong Kong, Mauritius and the British Virgin Islands.

Multinationals with multiple investment projects or foreign investment enterprises (FIEs) in China typically use China investment holding companies (CIHCs). The approval conditions for such holding companies are stringent;

1. The foreign investor must have a good reputation, creditability and financial strength;
2. Minimum registered capital of a CIHC is $30m;
3. Paid-up capital of the foreign investor's existing investment in China should not be less than $10m in aggregate;
4. Total assets of the foreign investor in the preceding year should not be less than $400m; and
5. The foreign investor should have more than three proposed investments approved by the Chinese authorities; or
6. If 3, 4 and 5 above are not satisfied, the foreign investor should have established 10 or more China FIEs that are engaged in manufacturing or infrastructure business and the total paid-up capital of these FIEs should be greater than $30m.

Dividends received by an investor are not subject to any Chinese tax and equally interest payments on borrowings to fund the acquisition of the equity investment are not tax deductible. A buyer may therefore need to structure the acquisition in such a way that the cost of funds are tax deductible elsewhere.

Similarly, feasibility costs, acquisition costs and investment management expenses are not tax deductible.

Structuring an asset deal

A typical asset deal model involves the formation of a new FIE or the use of an existing FIE to acquire the selected assets, liabilities and commercial operations of the target business.

The asset deal model is also commonly used in China when a Chinese partner injects its business into a joint venture. In other situations, rather than effecting a share deal, foreign investors may prefer to form a new FIE to take over the business operations of a target company so as to minimize their exposures to any inherent tax and business risks, hidden or contingent, that may be associated with the target.

An asset deal model would facilitate a 'step-up' in the cost base of assets which are eligible for depreciation or amortization relief. Acquisition goodwill is generally amortized and deductible for income tax purposes over a minimum period of 10 years.

Interest on debt used to finance an asset deal is not tax deductible.

Hong Kong

Hong Kong has a territorial tax system that imposes profits tax on a person carrying on a trade or business in Hong Kong on Hong Kong sourced profits. Income that is derived from non-Hong Kong sources is not subject to profits tax.

Hong Kong has been a special administrative region of mainland China since July 1 1997, and as such has a tax system which is based on common law and which is distinct from the tax system used in mainland China.

Structuring a share deal

Foreign investors typically structure share deals as direct investments from Hong Kong as Hong Kong source dividends are generally not subject to profits tax. In addition, capital gains are not taxable.

Interest is only deductible in Hong Kong if it is incurred for the purposes of produc-

Table 1: Frequently asked questions by foreign investors looking to invest in the following jurisdictions.

	China	Hong Kong	Indonesia	Philippines
General				
Are approvals required by foreign investors?	Y	N*	Y	Y
Are investment incentives available to foreign investors?	Y	N	Y	Y
Share purchase				
Is a local investment vehicle generally advised?	N	Y	N	N
Are dividends paid from the acquired entity taxable?	N	N	N	Y
Is interest relief available?	N	N	N	Y
Can losses be carried forward post acquisition?	Y	Y	Y	Y*
Asset purchase				
Is a step up in base cost possible?	Y	Y	Y	Y
Can goodwill be amortized?	Y	N	Y	N
Is interest relief available?	N	Y	Y	Y

* Some exceptions

ing assessable profits, and meets one of a number of specified conditions. Thus, interest paid on debt incurred for the purposes of acquiring shares (from which non-taxable dividends are derived) is not tax deductible in Hong Kong.

However, share dealers and venture capitalists that carry on business in Hong Kong are treated differently. They will normally be taxable on share disposals, but should be allowed a tax deduction for interest on debt used for the share acquisition.

A share deal may be preferable to an asset deal in the following situations:

- where the target company has significant brought forward losses;
- real estate in the target company, which would result in a significantly higher stamp duty cost if an asset purchase took place;
- potentially higher tax bases for depreciable assets; and
- simplified transaction formalities (for example, contracts may remain undisturbed).

Structuring an asset deal

The following points should be noted in relation to asset deals in Hong Kong:

- Real estate should be transferred at market value, otherwise the value for stamp duty purposes may be challenged;
- The tax authorities have the power to deem transfer of assets between connected persons for tax purposes at market value;
- Inventory may be assigned at any chosen value (irrespective of whether the parties are connected persons or not), if the transfer results from a cessation of business and the buyer can claim a Hong Kong tax deduction for the inventory cost. Otherwise, market value should apply;

Payments for goodwill are not tax deductible. However Hong Kong does provide tax relief for the acquisition of patent rights, capital expenditure on market research, feasibility studies and other research activities related to business and management sciences.

In the case of an asset deal, a tax deduction in Hong Kong may be obtained for financing costs, if certain conditions are met. In principle, interest on finance obtained from a Hong Kong or overseas financial institution is deductible, but interest paid to a non-financial institution is generally only deductible if the interest is subject to Hong Kong profits tax in the hands of the recipient (unlikely in the case of an overseas company).

There are further conditions which permit a deduction in certain circumstances for interest paid on loans to solely finance the acquisition of stock and fixed assets and on debentures and marketable instruments.

Interest deduction restrictions on intra-group financing exist, and complex structures are sometimes developed which may achieve the effect of an interest deduction for offshore finance, although at the risk of challenge from the tax authorities.

Indonesia

With a population of more than 200 million people and significant natural resources, Indonesia represents both a significant market and potential supplier to the world economy.

The Indonesian government officially welcomes foreign private investment and, over the past several years, has progressively sought to liberalize the local rules governing foreign investment. Since 2001, Indonesia has been in the midst of a serious effort to promote foreign investment, capital accumulation and the export of goods other than oil and gas to speed up economic development and to become internationally competitive.

Investors in certain industries and/or certain locations may be eligible for a range of tax-geared incentives.

Structuring a share deal

Foreign investment regulatory rules mean that most share acquisitions are structured as direct investments from outside Indonesia. The acquirer generally seeks to hold Indonesian target companies through a company located in a country which has entered into a double tax treaty agreement with Indonesia. The choice of a suitable jurisdiction will depend on the acquirer's own tax considerations.

Where a local corporate entity borrows to finance a share acquisition, interest is not generally deductible because dividends received are not taxable. Dividends are not taxable when:

- Dividends are paid out of retained earnings;
- The relevant shareholders hold at least 25% of the paid in capital; and
- The relevant shareholders have an 'active business' other than shareholding (that is, a holding company).

Interest on borrowings used to finance equity investments in newly established companies or to participate in rights issues is, however, deductible.

A change in ownership of the shares of a company does not alter the depreciation allowances claimed by the company or its carry-forward tax losses.

There is no facility for stepping up or increasing the cost base of assets to reflect the purchase price.

The acquisition of shares in a tax loss company provides flexibility in loss utilization because of Indonesia's lack of provision with regard to continuity of ownership or business.

Structuring an asset deal

An asset acquisition is subject to the approval of various government departments including Indonesia's Investment Coordinating Board (BKPM).

The acquisition of assets may be effected either by an existing subsidiary company or through a newly established Indonesian entity.

Generally, an asset acquisition is preferred in Indonesia because of the difficulties in determining the undisclosed liabilities (such as tax) of operating Indonesian entities. The Indonesian Tax Authority has 10 years in which to initiate a tax audit and therefore potential tax exposures can arise long after an acquisition has been completed. In addition, legal uncertainties in trying to enforce warranties and indemnities against vendors generally mean that asset acquisitions are preferred.

The buyer in an asset acquisition would be entitled to deductions for interest expenses on loans used to acquire such assets, if the assets are used in generating income and the transaction has taken place at arm's length.

On an acquisition of assets, the assets should be recorded at transfer value. An asset appraisal is generally required for a related-party transaction to determine the market value.

Asset depreciation is calculated on an asset-by-asset basis. Buildings are divided into two classes: permanent (useful life of 20 years) and non-permanent (useful life of 10 years).

Amortization on purchased goodwill and intangible property is generally tax deductible.

In addition, costs incurred to extend rights over land such as rights to build, rights to commercial use and rights to use, can be amortized over the useful life of the rights. Land acquisition costs are non-deductible.

The Philippines

The Philippines imposes income tax on income derived in the Philippines, and on income, which is derived outside the Philippines and received in the Philippines.

Capital gains are subject to taxation depending on the nature of the underlying transactions.

Various incentives are available for industries and activities encouraged by the Philippines government.

These include:

- Board of Investment-registered enterprises;
- Philippine Economic Zone Authority-registered enterprises;
- Subic Bay Freeport-registered enterprises;
- regional headquarters; and
- regional operating headquarters.

Entities carrying on approved activities may take advantage of reduced/preferential tax rates or full exemption from income tax and certain taxes for a specified period (generally between four years and eight years) depending on the nature of the tax incentives.

Structuring a share deal

The Philippines charges a 10% accumulated earnings tax on retained profits which are considered unreasonable. The onus is on the company to show that profits are retained for reasonable business purposes. The existence of a Philippines holding company would in general suggest unreasonable business purposes and as such, the use of a Philippines holding company as an acquisition vehicle is generally not recommended.

Care is needed to minimize capital gains tax on the disposal of the Philippines investment as all corporations, whether domestic or foreign are subject to capital gains withholding tax on the sale of shares. If the holding company of the Philippines investment is located in a country with a favourable double tax agreement with the Philippines, for example, the Netherlands or Singapore, it may be possible to exempt any gain from Philippines tax.

Interest on debt used to fund the acquisition is generally deductible.

There is no specific debt-to-equity ratio prescribed for tax purposes and deductibility of interest is largely dependent on whether the transactions between the related parties are considered arm's length.

In practice, a debt-to-equity ratio of 3-to-1 is often used as a safe haven as this is also the ratio required for entities registered with the Board of Investment as a condition for the incentives.

The professional fees and transfer taxes associated with a share acquisition and which are borne by the purchaser are normally treated as being part of the cost of investment.

The tax losses of a target company will be lost if the acquirer obtains more than 25% of the shares of the company. For any tax incentives to be retained, approval from the relevant government body must be obtained.

Structuring an asset deal

For assets deals in the Philippines, care should be taken to ensure that income tax, value-added tax and local business tax (based on gross selling price), documentary stamp tax and transfer tax (particularly with respect to the transfer of property) are minimized.

Where real estate is involved, documentary stamp tax, transfer tax, and local business tax on the transfer may be significant costs.

Interest incurred on funds used to acquire a business under an asset deal is tax deductible.

An asset deal also allows the buyer to step up the cost base of acquired assets for tax purposes. This enables tax deductions to be maximized through depreciation or amortization.

Amortization of goodwill is not tax deductible, but certain business rights may be amortized for tax purposes.

Tax needs wider consideration

Making an investment in China, Hong Kong or elsewhere in the region is typically regarded as a long-term business commitment. While large international businesses may have China or Hong Kong in their sights other locations have their own merits. The relevant tax issues do need to be considered in a broader context.

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