

# taxtalk

newsletter

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Tax planning is alive and well, but taxpayers need to be aware of changes in the attitudes of tax authorities and international bodies, particularly with regard to an increased focus on transparency and combating tax leakage.

The following examples illustrate some of the factors to be considered in the current planning environment:

### **Organisation for Economic Co-operation and Development (OECD):**

In 2000, the OECD identified a number of countries they considered to be tax havens. This list, which did not include Hong Kong, included countries such as Barbados and BVI. Not wanting to be included on the list of tax havens, many of these countries have introduced, or will shortly introduce, additional regulations to promote transparency and exchange of information with OECD member countries on taxation matters.

### **Financial Action Task Force on Money Laundering (FATF):**

FATF is an inter-governmental body whose purpose is the development and promotion of policies, both at national and international levels, to combat money laundering and terrorist financing. As a result of its work, many countries, including Hong Kong, have adopted Money Laundering regulations which require professional advisors, banks etc. to "know their clients" and to report to the authorities when they suspect Money Laundering. It should be noted that Hong Kong has consistently met the FATF standards.

### **Exchange of information**

**agreements:** The US has signed exchange of information

agreements with various countries including the BVI, Jersey, Guernsey and Switzerland. Under these arrangements, the US may obtain information about activities taking place in countries which in the past had secrecy laws.

**European Union:** Like the US, European governments also believe that exchange of information among tax authorities is the best way to enforce tax laws on taxpayers with cross-border income. Therefore, the European Union has issued a Savings Directive. Under the Directive, banks that pay interest to individuals in prescribed territories are required to report information of the relevant payees to the governments, which will then share the information with each other. The payees are required to provide their identity and residence information to the paying agents, or face a withholding tax obligation.

**Tax scheme reporting:** The US has formed a task force with the UK to share expertise, practices and experiences in tackling abusive tax schemes. Both countries have introduced reporting requirements in relation to tax schemes and offshore transactions.

**Anti-avoidance legislation:** Countries are introducing more legislation to combat tax leakage; examples include anti treaty shopping clauses, Controlled Foreign Company and Transfer Pricing rules.

Greater transparency is a requirement of current tax planning. However, where there are commercial transactions or group structures to be put in place, advance tax planning can still achieve significant tax savings. Existing tax structures and planning should be reviewed on a regular basis to ensure that the arrangement remains up to date and effective.

# Structuring your international business

Tax should be seen as another business expense and controlled in the same manner. In the case of international businesses, the group structure usually evolves over time, and in many cases group structures currently in place are overly complicated, inflexible, not tax efficient, and administratively costly to maintain. In many cases there are opportunities to restructure and reduce both the administration and tax costs.

Equally it is important for new businesses to plan in advance and set up their structures correctly the first time.

## Initial Assessment

Step one will be to consider the current or proposed operations and structure, and plans for the future. It will be important to assess three key factors: the shareholders' goals, the location of the current or proposed business, and the current group structure.

### i. Shareholders' goals

Whilst it may be less relevant to public companies, consideration of the shareholders' goals is important. Certainly, there is no one-size-fits-all tax structure.

While the common goal of most businesses is profit-making, the goals and tax implications of the shareholders are not necessarily the same for all companies. Some investors may be interested in receiving annual dividends, while some in listing or trade sale, and others in passing the business to the next generation. Coupled with this are issues such as the

timeframe involved, future tax position of the shareholders, estate planning etc.

An effective tax plan will take these shareholder goals into account as part of any international structuring.

### ii. Current or proposed business operations

A group may choose where to set up its holding company, but may have less choice for its operating companies, the decision on which is often dominated by the nature of its business and location of customers. This does not mean that there are no planning opportunities. Through careful planning and analysis of the functions carried out, it is possible to reduce taxes at the operating company level.

### iii. Holding company

The holding company will influence both the tax position of the operating companies (both direct and indirect via withholding taxes), within the group and ultimately on the shareholders (again, both direct and indirect). It is therefore essential to review the current structure to help control the group tax expense as in many cases the structure may have evolved over time with the result that it is not tax efficient and is overly complicated to administer.

Whilst not exhaustive, the following are the ideal criteria for a holding company location:

- A wide network of tax treaties. Tax treaties are arrangements between governments that override

domestic tax legislation. Their purpose is to help reduce double taxation. Typically, such agreements help define residence for tax purposes so that a company is only resident and taxable in one country. In addition, they generally reduce withholding taxes, for example, on dividends, interest and royalties;

- Low Corporate Income Tax rates or no tax on Foreign Source Income;
- No tax on incoming or outgoing dividends, interests, royalties etc.;
- No Capital Gains Tax when underlying businesses are sold; and
- Low stamp duties on transfers of shareholdings.

Within Asia Pacific, the typical jurisdictions to be considered are Singapore, Hong Kong, and Malaysia, although it should be noted that as part of Australia's overhaul of its corporate tax legislation, Australia will be a country worth considering in the future. Within Europe there are many possibilities, including the UK, Cyprus, Netherlands, Sweden, Denmark, Switzerland etc. Each of these jurisdictions has its own distinct advantages and disadvantages.

It should be noted that often the ideal holding company location is the same, and perhaps may even be the same company, as one of the operating



subsidiaries. Besides ease of administration, it can also have tax advantages.

### Structuring

International structuring is often a balancing act between ease of administration and tax savings. Whilst not exhaustive, and not in order of priority, the following are some of the common considerations:

- **Corporate Residence and type of entity.** Deciding where you will have a tax base and what form that entity should take, for example, a company, a branch or a representative office;
- **Profit Repatriation and withholding taxes.** Considering the tax consequences of profit flows within the group, both direct and indirect via withholding taxes, and ultimately to the shareholders;
- **Financing.** Should the business be funded via debt (loans) or equity (shares), and should these be from third parties or internal. This is particularly relevant as some countries, such as China, either disallow interest expenses or treat them as dividend distributions when the prescribed debt to equity ratio is exceeded. Another example is Hong Kong, where an interest expense paid overseas may be disallowed, whereas under the lending country's transfer pricing legislation, interest is required to be charged. By planning in advance, it is possible to ensure that the group maximise its allowable interest

deductions and avoid unexpected surprises;

- **Tax treaties and Limitation on Benefits or Anti-Treaty Shopping clauses.** In designing a tax efficient structure, tax treaties can certainly help, particularly in connection with withholding taxes. However, many countries have within their tax treaties, Limitation on Benefits and Anti-Treaty Shopping clauses. These seek to limit the applicability of a tax treaty where there is a lack of substance, i.e. the main purpose of interposing a company is to take advantage of a tax treaty. By understanding the limitations, it is possible to ensure that the treaty will apply;
- **Controlled Foreign Company (CFC) Legislation.** Many countries have CFC provisions. These are anti-avoidance rules aimed at preventing companies from shifting profits to low or no tax jurisdictions. These anti-avoidance provisions take many forms, but in essence they seek to tax profits accrued in low tax jurisdictions on an arising basis, regardless of whether the profits are repatriated. Many of these CFC provisions grant exemptions for genuine trading companies, but tax passive income such as royalties and interest. Knowing the rules may facilitate tax planning. For example, under the passive income or passive asset threshold tests, it maybe possible to plan ahead so that the shareholders would not be taxed on foreign income on an arising basis; instead, tax may be deferred until repatriation. For example, there may be a 5% passive income test after which all of the foreign income would be subject to tax. By having two companies, it may be possible for the passive income only to be caught by the CFC legislation, whereas the trading income is not taxed until dividends are paid;
- **Utilising losses or group relief.** It will be important to avoid a problem that often arises where one country pays income tax whereas another company in the group has unutilised losses;
- **Transfer pricing.** Transfer pricing describes the process through which related companies charge prices between each other. As part of any tax structuring it will be necessary to assess profit flows within the group and ensure that there is adequate documentation to meet the relevant Revenue Authority requirements. This is an essential part of the planning process and can result in tax savings;
- **Foreign Exchange Controls.** For example in China, India and Korea. The proper approvals and registrations need to be arranged at the outset to ensure that it is possible to repatriate profits, make loan payments etc to non-resident shareholders.

Successful tax planning involves planning in advance with a consideration of all the factors involved, including non tax issues. This integrated approach to tax planning can result in significant tax savings.

# Macau Offshore Institutions



In recent years many multinational groups have considered using Macau as part of their overall trading structure in Asia.

## Offshore regime

The Offshore Law of Macau provides for the regulation of Offshore Institutions, the main tax advantages being full exemption from various kinds of Macau taxes, including complimentary tax (profits or corporation tax), industrial tax (business registration fee), property tax, stamp duties and professional tax (income tax) for non residents.

## Permitted activities

There are currently 20 approved activities, including overseas selling activities, data processing, documentation services, back office support etc. The main requirements are:

- The employment of local resident staff in Macau. Two staff are generally taken as a benchmark;
- An independent office in Macau;
- No trading with Macau residents;
- The submission of an investment plan.

It is a condition of renewal of the offshore status, that the investment plan is carried out.

## Practical issues

The Macau offshore regime offers a unique

opportunity in Asia Pacific to establish a tax free entity for regional operations. However, there are practical issues to be considered:

- Given the proximity of Hong Kong to Macau, the Hong Kong Inland Revenue Department may look closely at Hong Kong companies relocating their businesses to Macau. It will therefore be important to ensure that the Macau entity has real substance.
- The infrastructure in Macau may not be sufficient to meet the company needs, for example, availability of staff and premises, transport links, telecommunications, banking, professional support etc.

## Overseas tax issues

The use of a Macau Offshore Institution in a group structure may offer a number of advantages, not the least of which is the certainty afforded by the exemption from Macau taxes offered by the Macau government.

However, for multinational groups, this must be considered in conjunction with taxes in other jurisdictions.

For example:

## i. CFC legislation

Many countries have Controlled Foreign Company (CFC) provisions as discussed in more detail in the article on tax structuring. It will be necessary to examine whether such provisions will apply to Macau and, if so, whether an exemption can be arranged.

## ii. Participation exemption

Many multinationals have a group holding structure, where the holding company is located in a country with a tax exemption on dividends received and capital gains from foreign subsidiaries. However, in general, there is a requirement that the underlying company pays corporate income tax in the foreign jurisdiction.

## Conclusion

In the appropriate circumstances, the use of Macau Offshore Institutions may provide a tax efficient planning opportunity, especially in situations where the group's operations are located in Southern China. However, as with all tax planning, it is necessary to consider the wider aspects, including the costs involved in establishing and maintaining an office, the availability of appropriate staff and premises, the repatriation of profits and the overall tax impact for the group.

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