CORPORATE TAX PLANNING

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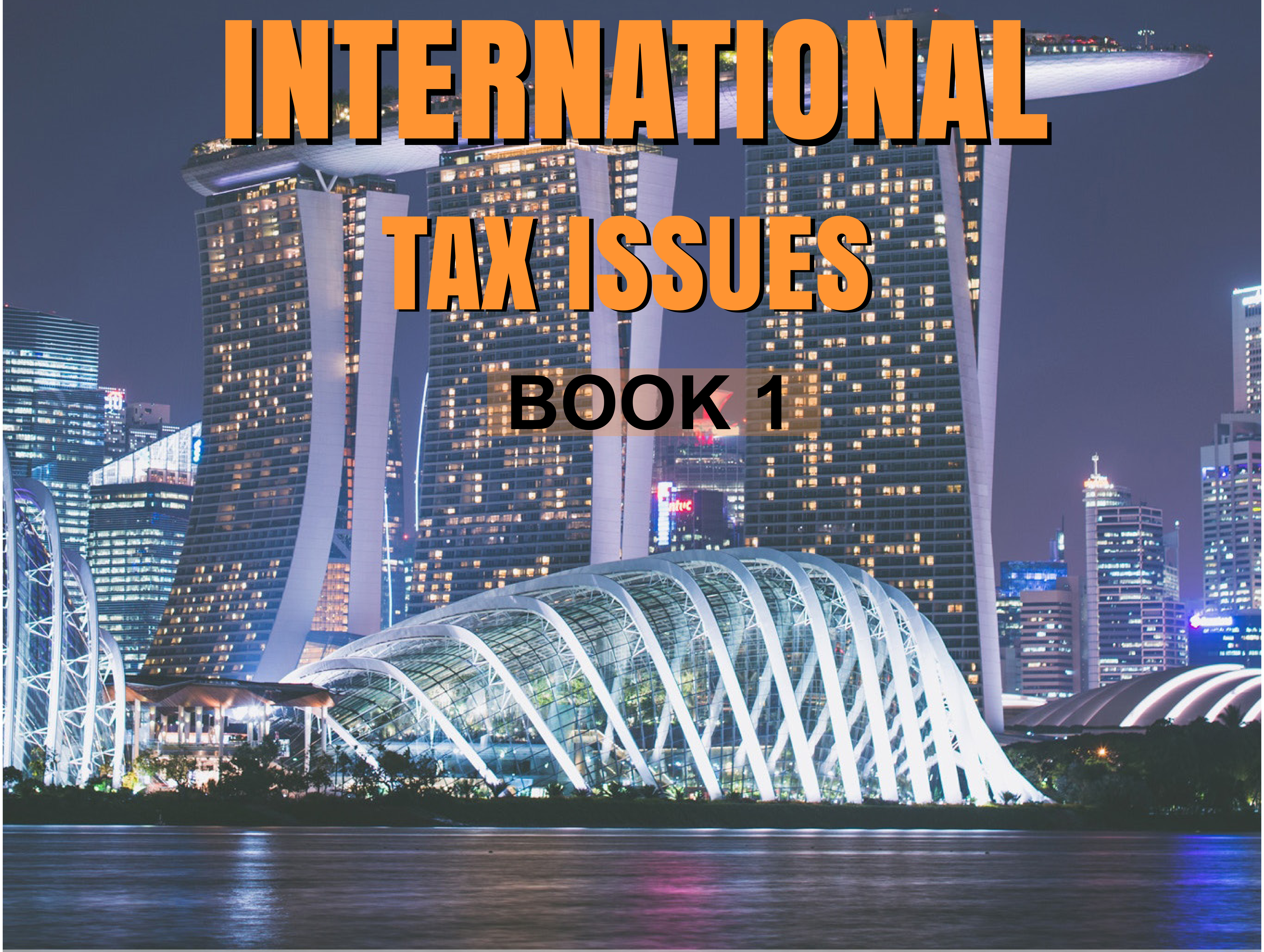
INTERNATIONAL TAX ISSUES

BOOK 1



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CORPORATE TAX PLANNING

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FOREWORD

The focus of this booklet is to highlight the risks and opportunities in international tax structures for entrepreneurs, family businesses and SMEs that are operating in an international environment. Many large conglomerates make use of international structures with the help of their army of tax advisers, both internal and external. These structures can create very low effective tax rates, making such enterprises very competitive.

Smaller players in the market have to respond to remain competitive, or risk being sidelined by large conglomerates. Risks and opportunities that apply to large conglomerates are applicable also to smaller players operating in the international environment. Thus, it is important for smaller players to be informed of the risks and opportunities of operating in an international environment, and to access for themselves similar tools that are available to large conglomerates.

Singapore has been used by large conglomerates as an attractive location for their international tax structures. It is also able to offer similar benefits to entrepreneurs, family businesses and SMEs.

Contact PHP if you need further advice and information concerning issues covered in this booklet.

INTRODUCTION

Entrepreneurs, family businesses and SMEs operating across national border face similar risks and opportunities that large conglomerates handled with a team of internal and external advisers. Although managing these risks and opportunities can be more challenging for smaller players because of lack of resources, it is a question of survival in the long term that motivate such players to examine similar risks and opportunities.

Recent evidence coming from various sources suggests that large conglomerates have been managing their international tax exposures very effectively. Using a combination well known techniques sanctioned by governments around the world, these enterprises were able to reduce their global effective tax rates to unprecedented levels. Such practices are under scrutiny currently due to the OECD/G20 initiatives under the Base Erosion and Profit Shifting (BEPS) Action Plan.

Even in the context of recent developments in the OECD/G20 BEPS Action Plan, international tax structuring is not optional for entrepreneurs, family businesses and SMEs operating in an international environment. The recent developments in OECD/G20 must, of course, be taken into account in any such international tax structuring, just as these developments are expected to influence the international tax structures of large conglomerates.

A. Structuring for Entrepreneurs

This segment will illustrate the importance of international tax structuring for an entrepreneurs with a sound business idea trying to exploit the idea globally or regionally using digital economy

B. Structuring for Family Businesses

This segment will illustrate the important of international tax structuring for a family business in Malaysia expanding their manufacturing and distribution operations beyond the domestic market to neighboring countries

C. SMEs going global

This segment will illustrate the case of an SME in China going global in search of new clients/markets in South East Asia under the Chinese 'one belt, one road' policy.

INTERNATIONAL TAX ISSUES

Entrepreneurs, family businesses and SMEs operating globally can do so in a number of ways. Global businesses can be operated remotely from the home countries, through a local subsidiary or using local branches. These different options create different international tax obligations that have to be managed carefully.

There are generally four main international tax risks for global businesses: with holding taxes, permanent establishments, transfer pricing and value added taxes (VAT) (or goods and services taxes, GST). These risks, which are closely associated with cross border transactions, are no different for entrepreneurs, family businesses and SMEs than they are for large multinationals.

Some of these international tax risks can arise in all business models, while others are more linked to specific models. For example, transfer pricing risks are associated mostly with transactions between associated enterprises. As such, this is typically an issue only when there are transactions involving the foreign subsidiary. On the other hand, withholding taxes, permanent establishments and VAT/GST are all issues that can arise across all business models.

International tax planning ensures that international tax risks and the associated compliance and administrative obligations are properly highlighted and managed. Without proper international tax planning, there is a risk that income from cross border investments would be subject to double taxation. Proper international tax planning also optimizes the after tax returns of cross border investments. Indeed, many cross border investments would be untenable without proper international tax planning.

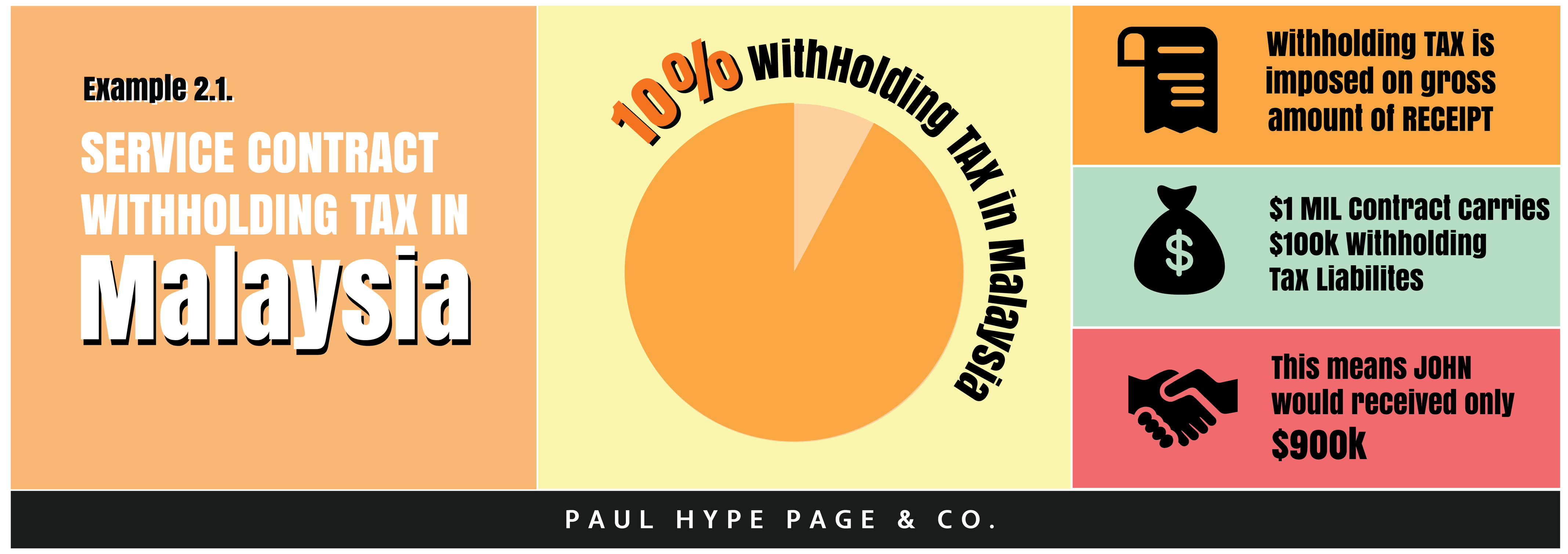
2.1. Withholding taxes

Withholding taxes are imposed by many countries on payments made to non-residents. These taxes are imposed on a wide range of income, such as investment income (i.e. dividends and interest), royalties, capital gains and fees for technical services, when they are earned by non-resident investors/operators.

Withholding taxes are usually imposed on the gross amount of the income. As such, these liabilities can be quite significant relative to the profits of the entrepreneurs, family business and SMEs. This is the case, in particular, for entities operating in certain industries where the profit margins tend to be relatively small compared with the gross receipts that are subject to withholding taxes. Therefore, managing and minimizing cross border withholding tax liabilities in the host countries and maximizing the possibility to credit foreign withholding taxes in the home country are especially important for such businesses.

Example 2.1.

John is an engineer and owner of a small service company in Australia. His business has grown in recent years to other countries in Asia, including Malaysia. Contracts in Malaysia are handled directly from John's company in Australia. John's company has no substantial presence in Malaysia, although John does have to visit his clients to discuss their requirements from time to time. For the most part, however, John has been able to communicate from Australia, via skype, with his clients in Malaysia.



Such service contracts are subject to a 10% withholding tax in Malaysia. The withholding tax is imposed on the gross amount of the receipt and the payer is obliged to make the withholding. This means that a $1 million contract would carry a $100,000 withholding tax liability and John will receive only the balance of $900,000. **Failure to withhold will mean additional liabilities and penalties for the payer.**

To the extent that John has to bear this tax liability, he may be able to obtain a tax credit back home in Australia for the withholding taxes paid in Malaysia. However, John may not be able to utilize the tax credit fully as his taxable income in Australia is calculated on a net basis after his expenses. For example, if John incurred tax deductible expenses of $800,000 in Australia in relation to the $1 million contract in Malaysia, his company's taxable income will be $200,000. His tax liability, assuming an average 30% tax rate, will come to a tax liability of $60,000 in Australia. This means that the additional $40,000 withholding taxes paid in Malaysia would be un-creditable and as such represents an additional tax cost for John. This makes John's effective tax burden 50% of his profits.

In such cases, it may be important for John to manage his withholding tax obligations in Malaysia. For example, John may be interested to know that a lower rate may be available under tax treaties that Malaysia has entered into with other countries.

Entrepreneurs, family businesses and SMEs may face withholding tax issues also at the end of the investment process – i.e. when they sell their foreign investments. Capital gains such enterprises make on the direct and indirect transfers of shares in foreign subsidiaries may give rise to withholding tax liabilities in the countries where the subsidiaries are resident. Even purchasing initial investments can have withholding tax liabilities, as the purchaser (in his capacity as payer of the income) may be liable to withhold taxes due on capital gains earned by the seller.

Such obligations may include, among other things, withholding at the appropriate rate, remitting the appropriate amount within the specified time to the tax administration, maintaining appropriate records and supplying the correct documentation. This risk is highlighted most strikingly in the controversial case in India involving Vodafone International Holdings B.V. (Vodafone NL) (SLP(C)No. 26529 of 2010).

Example 2.2.

Mr. Lim, the patriarch of a family business specializing in manufacturing and distribution of plastic home-ware in Malaysia, is looking to expand his family operations offshore. Through his business associates in India, he has identified a group of companies which fits in with his expansion plan. He intends to buy this group, which consists of a number of companies scattered all over the world, although most of the valuable assets are located in two companies in India.

Such a purchase has a withholding tax risk in India, as India impose 20% withholding tax on capital gains on the disposal of shares in Indian companies. Although, in theory, the tax is imposed on the seller, who is the earner of this income, the purchaser is often the party obliged to withhold such taxes in practice from the purchase price and remit them to the Indian tax authorities.

As such, Mr. Lim, as the purchaser of the group of companies in India has to be aware that there is a withholding tax obligation in India. As the first step in dealing with this withholding tax risk, contract negotiation with the seller needs to be conducted with this understanding in mind. Mr. Lim would also be expected to comply with a range of administrative obligations to collect and remit the withholding taxes to the Indian tax authorities in a timely and accurate manner.

Furthermore, since such a withholding tax liability is likely to exist for Mr Lim when it is time for him to sell his investments India, it may be important to also consider if there is a better way for him to manage this tax liability. One possibility is to use a holding company to ensure that capital gains that Mr Lim makes eventually will not be taxable in India.

2.2. Permanent Establishment

For cross border businesses, taxation obligations in the country of operation are often tied to the concept of 'Permanent Establishment' (PE), a unique and troublesome international tax concept. Broadly speaking, when a PE is found to exist in a country, that country typically would have the right to tax profits that are attributable to the PE, regardless of where those profits come from. In addition, there are compliance and administrative obligations attached to such PEs, as countries often required them to be registered for tax purposes and file tax returns. Failure to meet such obligations often carries sanctions and penalties.

As a result of the tax costs associated with PEs, as well as the associated administration and compliance costs, managing PE risks in cross-border business operations is the core objective of many international tax structures. However, managing PE risks in cross border business operations is not an easy exercise – the concept of PEs is very complex technically, and how these rules apply to real-world scenarios can often produce unexpected surprises.

Example 2.3.

X Co is a newly established SME in Germany. It offers an internet based software solution for its clients to manage their accounts receivables, together with access to local support including debt management services. The local debt management services are provided by X Co either through its subsidiaries in the country or through local third party agents. In some countries where X Co does not have subsidiaries, the services are performed only through local agents.

X Co signs all the contracts with its clients via the internet. Customers find most of the information they need online, although local subsidiaries also provide some support in answering the questions that potential clients may have about the software technology and their services. Once the contract is concluded online, the clients will access the software solution. The staff of the subsidiaries will service the clients from time to time.

In such cases, profits that X Co earned in various countries may be taxable in those countries if it is found to have a PE there. The PE risk is closely linked to the operational arrangements and the conduct of the parties involved. For example, the server hosting the software may constitute a PE and thus its location should be considered carefully. A PE may be found if X Co has a fixed place of business where it sends its staff regularly to meet with clients in a particular country. The staff of the local subsidiaries may be acting for X Co in such a way that they constitute a PE of X Co. All these considerations often mean that the availability of premises (such as offices or hotels) and the conduct of local staff need to be monitored and controlled to minimize X Co's PE risks.

Nevertheless, PEs can be a useful international tax planning tool. Many countries eliminate withholding taxes on cross border income under their domestic law, or are obliged to do so under their tax treaties, when a PE is found to exist in the country and the income is attributed to that PE. Instead, profits that are attributable to the PE are taxable after expenses are deducted. Thus, businesses with significant expenses may prefer to have a PE so that expenses they incur in generating their income in a particular country can be deducted against the PE income.

Example 2.4.

In the case of John in Example 3.1, it is possible that he has a local branch in Malaysia to carry out the engineering contract in Malaysia. If this branch has the necessary staff to carry out the contract, profits generated from the contract may be attributed to the branch. In this case, the contract revenue will be exempt from the 10% withholding tax. Instead, the branch profits would be taxable in Malaysia, after deducting related expenses, on a net basis at 25% income tax rate. Assuming that the same level of expenses was incurred resulting in profits of $200,000, John's tax liability in Malaysia would be $50,000, instead of $100,000 under the withholding tax rules.

2.3. Transfer Pricing

When entrepreneurs, family business and SMEs operate internationally using different companies, it is important to recognize that transactions between these companies can be priced in a particular way to maximize the after tax profits of their global operations. Pricing goods and services supplied by a company located in a low tax jurisdiction at a 'high' price would shift profits to that entity in the low tax jurisdiction, while decreasing the profits in the payer company. This has the effect of maximizing global after tax profits of the group as a whole.their income in a particular country can be deducted against the PE income.

Transfer pricing practices within a multinational group are, however, governed by international standards known as the arm's length principle, which requires that transactions between associated enterprises are priced in accordance with the terms and conditions that would have been agreed to between independent parties. Many countries have adopted this principle to curb potentially 'abusive' transfer pricing practices that multinationals may carry out. In addition, countries may also impose requirements for taxpayers to prepare and file contemporaneous documentation to justify the pricing practices. Failure to comply with these requirements would mean not only an adjustment to taxable profits but also penalty and sanctions for the tax shortfall and/or the lack of documentation.

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Example 2.5.

Mr. Ren is a Taiwanese entrepreneur who has inherited the family business of manufacturing and distributing aluminum containers. Upon taking over the family business, Mr Ren discovered that the business consists of a group of companies, with its headquarters in Taiwan from which sales activities are carried out. For many years, the company in China has been responsible for sourcing the raw material and manufacturing the aluminum containers. The raw materials were purchased from third party suppliers in Australia, but all the finished goods are sold to a group company in Hong Kong. The group company in Hong Kong then invoices the third party customers in other countries. The pricing on these transactions are such that a significant proportion of the group profits are left in the company in Hong Kong.

The use of an invoicing company to channel profits to low tax jurisdictions has been coming under scrutiny internationally. This practice is considered aggressive by many countries from a transfer pricing perspective. Chinese tax authorities may question the price charged on the finished goods sold to the Hong Kong company, while the Taiwanese tax authorities may also question the lack of an appropriate remuneration for the sales functions carried out by the headquarter company in Taiwan.

A proper re-consideration of the transfer pricing practice would need to address the functions performed, assets used and the risks assumed by the Hong Kong company to ensure that its contributions to the global value chain is consistent with the profits attributed to it. If this is possible to achieve, then Mr. Ren would also need proper supporting documentation to justify the group's transfer pricing practices.WWW

As such, transfer pricing practices within the international operations have to be managed in a way that balances the optimization of global after tax profits, while conforming to the arm's length principle. This balancing act requires a careful consideration of the rules that countries have put in place on the arm's length principle and the associated transfer pricing documentation requirements, in the context of the cross-border business operations of the entrepreneurs, family businesses and SMEs and the opportunities that they offer.

Example 2.6.

In the case of X Co (see Example 3.3), the SME in Germany operates in various countries through local subsidiaries. The local subsidiaries provide some support in answering questions that potential clients may have about the software technology and their services. The staff of the subsidiaries will service the clients of X Co from time to time.

As these services are performed in the context of X Co's business, the local subsidiaries would have to be paid by X Co for the performance of these services. Such payments are likely to be subject to the arm's length principle – i.e. X Co would need to ensure that the remuneration is consistent with what third parties would have paid in comparable circumstances, and prepare to justify the remuneration based on contemporaneous transfer pricing documentation package.

As long as X Co is able to substantiate the remuneration paid to its local subsidiaries in the context of the arm's length principle (and manage its permanent establishment risks), the local tax authorities would have to accept that X Co has no further tax liabilities in their countries.

2.4. Value added Taxes /Goods and Services Tax

Cross border trade has not only income tax implications, but also indirect tax implications. Many countries impose value added taxes or goods and services taxes (i.e. VAT/GST) on cross border supplies of goods and services based on a 'credit invoice' system. Such a system would impose taxes on the 'consumption' of certain goods and services – i.e. taxes are imposed on the final consumers. However, these consumption taxes are collected by the suppliers on their value added component. For example, a manufacturer that buys raw material will pay VAT/GST on its purchases, but will impose taxes on the distributor that buys its finished products. The taxes that are paid on its purchases would give rise to input tax credits, which are deducted against the output taxes it collects from the distributor. As a result, the VAT/GST system requires the manufacturer to pay taxes on the value added component of its business.

Nevertheless, VAT/GST systems are complicated in practice. In a country's VAT/GST system, there are typically different rates for the taxable supplies of different types of goods or services. There are also certain supplies that are exempt from VAT/GST while others are simply 'zero-rated'. The complication created by these features arises because input credits incurred in the context of exempt supplies are not deductible whereas input credits associated with 'zero-rated' supplies are deductible. Understanding these differences in practice and managing their implications can be challenging for entrepreneurs, family businesses and SMEs.

It is not easy to understand fully the practical application of VAT/GST rules to cross border transactions. Even the simplest cross border transactions that global businesses carry out can create the most surprising VAT/GST issues. Mismanagement of VAT obligations can mean a tax liability based on the gross amount of revenue, or the loss of input tax credits for VAT/GST paid on taxable inputs such as raw material, goods and services - both out comes carry significant tax costs.

Example 2.7.

Ms Liu is a self made business woman based in China. Through her own network she has identified an opportunity to source second-hand vehicle tires in Malaysia, and to turn them into recycled rubber for manufacturer in Vietnam. She paid the Malaysian supplier $2 million for six container load of used tires. In addition, she pays a logistic company $50,000 to collect and ship these tires to Vietnam where her customers will collect them.

In Malaysia, the Goods and Services Tax (GST) will replace the sales tax and service tax from 1 April 2015. If applicable, Ms Liu would be liable to pay 6% tax on the supplies of used tires and the shipping services. Ms Liu may also be taxable (most likely at a 10% rate) in Vietnam under the local value added tax (VAT) rules upon the importation of the used tires. In addition, she may be required to register and file tax returns for GST purposes in Malaysia and for VAT purposes in Vietnam. Ms Liu would need to consider all the potential VAT/GST obligations in these countries when conducting her business there, as failure to do so could be even more costly.

It is not clear whether, and how, the registration rules would apply to a non-resident like Ms Liu. In addition, numerous exceptions and exemptions that are available under the domestic law of both Malaysia and Vietnam may be applicable to Ms Liu. These rules would have to be investigated and managed accordingly.

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