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The rapid expansion of Hong Kong's double tax agreement network is likely to create tax planning opportunities for global corporations with operations across Asia. Hong Kong is now a signatory of 17 DTAs, the most recent being the November finalization of a DTA with Japan and the December finalization of one with New Zealand. Although Singapore, with an extensive network of more than 60 treaties, is generally considered the most desirable holding company jurisdiction in Asia, Hong Kong is quickly mounting a serious challenge to Singapore's preeminence in this regard.

DTAs provide an added measure of clarity about when and to what extent a party will be taxed. When a DTA is applicable, a corporation can, with greater certainty, anticipate tax liabilities arising in a given jurisdiction and develop an optimal tax and supply chain structure as a result. Thus, as Hong Kong's DTA network expands, global corporations will likely benefit from incorporating Hong Kong into their respective tax and supply chain structures.

Permanent Establishments

Understanding the permanent establishment concept is critical to understanding how the right to tax business profits is allocated between each DTA signatory. For example, before the implementation of the Hong Kong-Japan DTA, Japan's domestic definition of PE will be used to determine when a Hong Kong company will be subject to taxation on business profits in Japan. Since Japan's domestic definition of PE is much broader than the definition included in the Hong Kong-Japan DTA, Hong Kong companies currently operating in Japan have a much higher PE risk than when the treaty provisions come into effect (likely in 2012).

Three types of activities conducted in the host country are commonly sufficient to create a PE under most DTAs:

- a fixed place of business;
- an agent; or
- construction-related operations.

Branch offices, factories, quarries, and places of management will each generally constitute a fixed place of business. Under the Hong Kong-Japan DTA, when an agent of Hong Kong Co operating in Japan has the authority to conclude contracts in the name of Hong Kong Co, and the agent is not independent, the agent will constitute a PE in Japan for Hong Kong Co. A PE also exists if Hong Kong Co is performing construction or shipping activities in Japan beyond a specified time period. However, preparatory activities, such as market research, liaising with customers, collecting information, and purchasing goods generally will not, by themselves, create a PE.

The importance of clarity regarding when an agent constitutes a PE cannot be understated. In the international commerce context, a company might operate in any number of foreign countries and have representatives situated therein. Adverse tax consequences result when the company is found to have a PE in a given country because of acts undertaken there by a deemed agent of the company. Thus, it is imperative to limit and control the conduct of representatives situated in foreign countries so as to prevent the inadvertent creation of PEs abroad.

While local law is sometimes unclear about what activities will create an agent PE, DTAs provide clearer guidance in this regard. As a result, a DTA enhances the ability of tax planners to reduce the likelihood that a foreign presence will be construed as an agent PE, and in the event that it is, the DTA provides tax planners with a framework through which to conduct negotiations with the local tax authority.

Hong Kong's Edge

When contemplating how to structure operations in Asia, many foreign companies identify Hong Kong as an attractive locale because of its proximity to mainland China and its English-based legal and tax regime. Yet Hong Kong's limited DTA network has precluded the territory from becoming the preeminent Asian jurisdiction in which to establish holding companies. Instead, Singapore, with its extensive treaty network, has become the choice holding company jurisdiction in Asia. To take advantage of Hong Kong's benefits while also utilizing Singapore's extensive regional treaty network, many multinational companies establish holding companies both in Hong Kong to hold Chinese subsidiaries and in Singapore to hold subsidiaries in the rest of Asia. Despite this strategy's benefits, potential inefficiencies result from it. Specifically, difficulties arise when redeploying cash across regional entities held in different holding companies. Planning a tax efficient market exit is also complicated by the added tax structure. Furthermore, additional costs result from the establishment of multiple entities for the sole purpose of obtaining DTA coverage.

As Hong Kong's DTA network expands, the need for multinational companies to maintain holding companies in both Hong Kong and Singapore will decline. Instead, depending on the nature of the business and the goals of the company, a holding company situated in Hong Kong may offer both proximity to and links with mainland China as well as access to a strong regional DTA network. Thus, with each successive DTA entered into by Hong Kong, multinational companies should reevaluate whether new tax structure and supply chain efficiencies might result from operating in Asia solely through a Hong Kong-based holding company.

Hong Kong's Tax Regime

As noted above, Hong Kong's tax regime is relatively straightforward and has one of the lowest effective corporate tax rates in Asia. Highlights include:

- a corporate tax rate of 16.5 percent;
- a purely territorial tax system (that is, foreign-source income is tax exempt, even if paid into Hong Kong);
- only one level of taxation of profits at the corporate level (shareholder dividends are not taxable);
- no withholding tax levied on interest or dividends paid to nonresidents;
- 4.95 percent withholding tax levied on royalties paid to nonresidents (a rate of 16.5 percent or 15 percent applies on royalties paid to an affiliate corporate entity or individual, respectively if the relevant intellectual property was formerly owned by an entity carrying on a business or trade in Hong Kong);
- no capital gains tax;
- no VAT or goods and services tax; and
- ability to carry forward losses indefinitely (but no carryback provision).

Individual tax rates compare favorably with most Asian jurisdictions (from 2 to 17 percent), and the system also operates on a territorial basis. (Only employment income arising in or derived from Hong Kong is subject to tax.)

China-Hong Kong Free Trade Agreement

The People's Republic of China and Hong Kong entered into a Closer Economic Partnership Arrangement (CEPA) in 2004, which provides a number of incentives to Hong Kong-based companies doing business in China. Some of these key benefits to qualifying Hong Kong service providers include:

- easier access to the P.R.C. market;
- no tariffs levied on the export of Hong Kong-produced goods to the P.R.C., subject to conditions; and
- preferential treatment in areas such as customs clearance, intellectual property protection, e-commerce, and transparency in law.

Tax Structure

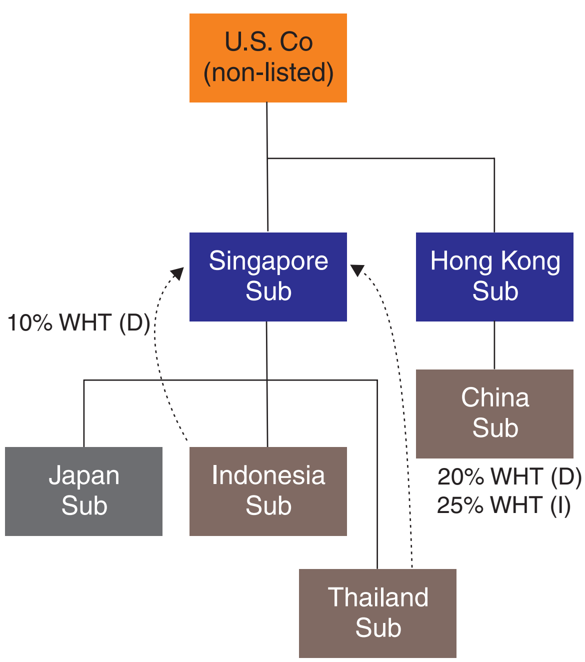
A multinational company's tax liability will likely differ depending on whether its Asian operations are structured through Singapore or Hong Kong. For example, U.S. Co is a U.S.-based software company with plans to expand into Asia. Depending on its circumstances, it may have the following objectives:

- secure U.S. tax deferral opportunities for its Asian-source income;
- create the capacity to redeploy cash among its Asian subsidiaries in a tax-efficient manner; and

- obtain the most favorable withholding tax rates available.

Interposing an offshore holding company between U.S. Co and its planned international subsidiaries might create significant tax deferral opportunities under U.S. tax law. Suppose that, like many other U.S. companies today, U.S. Co elects to include two entity chains in its Asian tax structure (as illustrated in Figure 1). A Hong Kong-based holding company will be created to hold a Chinese research subsidiary, and a Singapore-based holding company will be established to hold an Indonesian manufacturing subsidiary. Taxation by the United States of the subsidiaries' profits will potentially be deferred because such profits have not been repatriated to U.S. Co. Instead, those profits are being parked in the respective holding companies. For this tax deferral arrangement to be successful, the controlled foreign corporation rules of subpart F of the U.S. IRC must be satisfied (generally speaking, tax deferral is most often available under subpart F for income earned in the course of an actively conducted business).

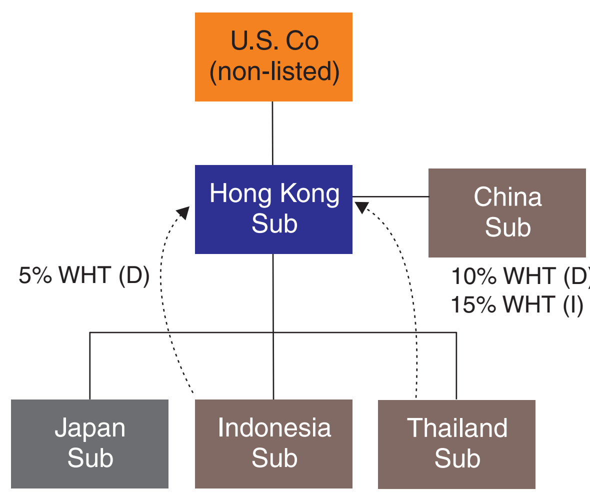
Figure 1. Traditional Asian Holding Structure



Difficulties may arise from U.S. Co's proposed Asian tax structure should the company attempt to redeploy cash among its Asian subsidiaries. For instance, cash to be moved from the Indonesian subsidiary to the Chinese subsidiary would likely have to be routed up the entity chain and through U.S. Co. This strategy may be inefficient from a tax viewpoint because it may expose the cash to potential taxation in the United States and, under the Indonesia-Singapore treaty, dividends distributed by the Indonesian entity to the Singaporean holding company would be subject to a 10 percent Indonesian withholding tax. Hong Kong, however, may provide a more tax-efficient solution.

Assume, because of Hong Kong's expanding DTA network, U.S. Co decides to reevaluate its planned Asian tax structure. Rather than establish two entity chains, U.S. Co instead chooses to hold both its Chinese and Indonesian subsidiaries in a Hong Kong-based holding company (as illustrated in Figure 2). This structure permits cash from one subsidiary to be routed to the other subsidiary through their mutual parent entity, the Hong Kong-based holding company. Since Hong Kong generally does not tax dividends received by taxpayers, and since cash does not move through U.S. Co, no adverse tax consequences are likely to result in either Hong Kong or the United States.

Figure 2. Simplified Asian Holding Structure (Via Hong Kong)



Moreover, the withholding tax rates offered by Hong Kong's DTA network are generally more competitive than the rates offered by Singapore's network. For example, under the Hong Kong-Indonesia DTA, dividends distributed by the Indonesian subsidiary to the Hong Kong holding company will be subject to a 5 percent Indonesian withholding tax. Compare this rate to the previously described structure where, under the Indonesia-Singapore treaty, an Indonesian withholding tax of 10 percent applied to dividend distribution by the Indonesian subsidiary to the Singapore holding company. When cash redeployment options and withholding tax rates are considered, Hong Kong emerges as a viable challenger to Singapore's status as the preferred Asian jurisdiction in which to establish holding companies. Similar opportunities arise if intellectual property is held in a Hong Kong IP holding company. Withholding tax rates levied on royalties under Hong Kong's DTAs with Japan, Thailand, and Indonesia compare favorably with those contained in Singapore's treaties with these jurisdictions.

Hong Kong also offers other advantages relative to Singapore that are subtle, yet no less important. Residency in a particular jurisdiction is a prerequisite to claiming the benefits of that jurisdiction's DTA network. Residency rules under the China-Hong Kong DTA and China-Singapore treaty differ, with added flexibility afforded to foreign companies established in Hong Kong. Any foreign company that is ''normally managed'' in Hong Kong is permitted to claim residence in Hong Kong for purposes of the China-Hong Kong DTA. However, the China-Singapore treaty exacts a more demanding standard, requiring that the foreign company's ''control and management'' be located in Singapore in order to claim Singaporean residency.

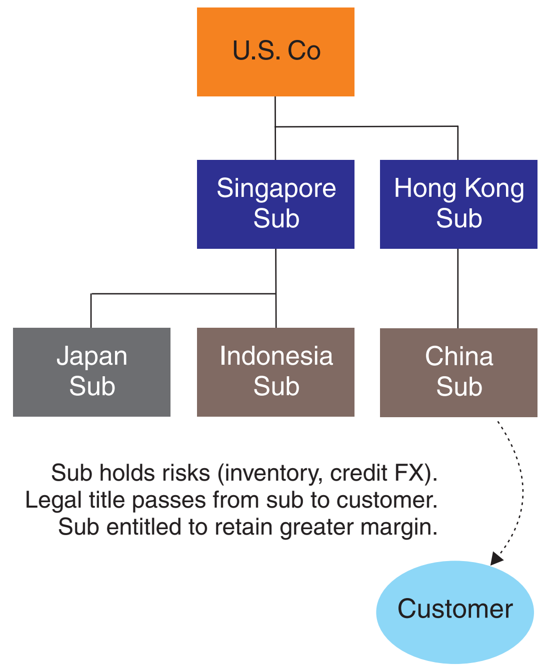
Supply Chain Management Implications

''Supply chain'' refers to the flow of goods and services within and between companies from the point of first supply to the ultimate customer. A company's supply chain includes not only its manufacturing operations, but its research, procurement, logistics, and distribution efforts. To deliver high profitability and low tax liability, effective supply chain management will seek to maintain operational and tax efficiency across these different business functions. An entity based in Hong Kong can be integral to promoting a tax efficient supply chain because of Hong Kong's favorable domestic tax rates, expanding DTA network, and continued adoption of international best practices.

Traditionally, entities in a company's supply chain have often operated in a discrete manner, each with its own business processes, risks, and profits. Business processes such as administrative or support services were undertaken by each entity, thereby creating duplicative functions and increased costs. Risk sharing is also minimal because, for example, a manufacturer might be exposed to risks associated with its capital investments while a distributor purchasing finished goods from the manufacturer would bear the credit risk emanating from sales on credit to customers. Profits arising from the activities in each jurisdiction would be attributed to the entity situated in that jurisdiction, leading to high tax costs when an entity was situated in a high tax jurisdiction or lacked access to an applicable treaty. Consequently, this structure created impediments to the attainment of operational and tax efficiency. (See Figure 3.)

A more effective supply chain management approach involves the streamlining of functions and risks through a hub entity, which will perform management, control, and sales functions on behalf of regional subsidiaries, known as operating entities. Routine functions such as research, administrative services, customer liaising, and logistical services can be executed by operating entities whose locations are determined by business and tax considerations. Because of its role in management and sales, a heightened share of the enterprise's overall risk will reside with the hub entity, permitting a greater share of the enterprise's profits to be allocated to the hub entity. Operating entities, whose roles are limited, will accordingly be exposed to a subordinate amount of risk, and will earn a smaller profit as a result. Moreover, by centralizing core business functions in one hub entity, costly duplicative services that would otherwise be performed by each regional subsidiary are avoided, thereby encouraging operational efficiency.

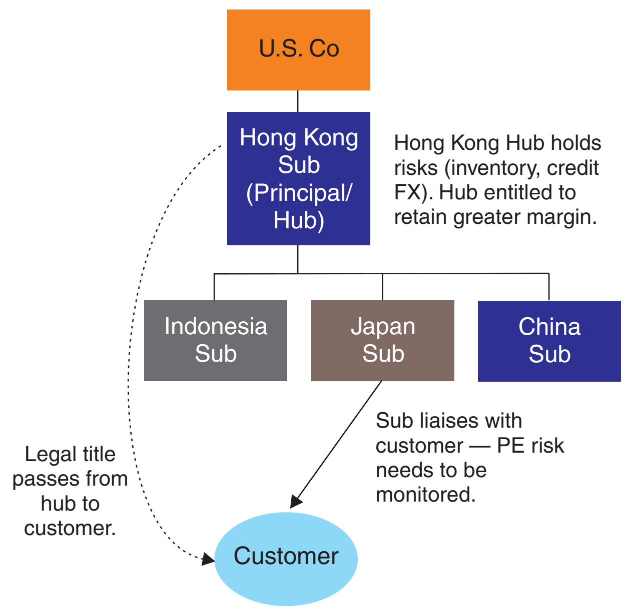
Figure 3. Inefficient Supply Chain Structure (Dual Holding)



Returning to the U.S. Co example above, by establishing a Hong Kong holding company, Hong Kong Sub, rather than holding companies in both Singapore and Hong Kong, U.S. Co is able to optimize the tax structure of its Asian operations. Now assume that U.S. Co has local subsidiaries in China, Indonesia, and Japan, all of which are held by Hong Kong Sub. Each local subsidiary liaises with customers and provides support and after-sales services, but are not directly involved in sales activities. Instead, Hong Kong Sub sells U.S. Co's goods directly to customers in each of the three Asian markets, with legal title passing directly from Hong Kong Sub to the customer. Hong Kong Sub recognizes income from the sales, thereby securing a low tax liability, and each operating entity is compensated by Hong Kong Sub for services provided. (See

Figure 4.) The hub supply chain model minimizes redundant business processes by forgoing the use of a Singaporean holding company and concentrating functions in Hong Kong Sub.

Figure 4. Tax-Efficient Supply Chain Structure (Hong Kong Hub)



The hub supply chain model presents benefits as well as risks. Here, Hong Kong Sub not only is acting as a holding company but also is undertaking management, sales, and other business functions. These added activities will decrease the likelihood that Hong Kong Sub is disregarded for tax purposes as lacking economic substance, a finding that would limit tax deferral opportunities. However, the activities of each local operating entity must be closely monitored to ensure that no local entity is deemed to be a PE of Hong Kong Sub. Here Hong Kong's expanding DTA network is once again useful, as Hong Kong's DTAs provide a degree of clarity relative to domestic law regarding when an entity will be deemed to be a PE in a particular jurisdiction.

Moving Forward

Though many U.S. companies currently structure their Asian operations through Singapore, Hong Kong is rapidly emerging as a preferential alternative. With its growing DTA network, access to China's burgeoning marketplace, and favorable investment climate, Hong Kong presents strong commercial and tax justifications for making it the focal point of an Asian entity structure. Moreover, the enhanced operational and tax supply chain efficiencies that result from an Asian presence structured solely through Hong Kong creates added appeal. Global corporations should therefore remain cognizant of the opportunities resulting from Hong Kong's expanding DTA network. ◆