



Indonesian Equity Investments — Selecting a Tax Efficient Holding Jurisdiction

A comparison of Hong Kong and Singapore in light of the new Hong Kong-Indonesia tax treaty

Joel Hogarth
+65-6593-1866
jhogarth@omm.com

Lawrence Sussman
+86-10-6563-4205
lsussman@omm.com

Anita Choi
+852-3512-2377
achoi@omm.com

Janice Seah
+44-20-7558-4846
jseah@omm.com

We have written extensively on the tax structuring of financing transactions in light of the substance requirements imposed by the Indonesian tax regulations passed in late 2009 (the “**Beneficial Owner Regulations**”).¹ While the most obvious implications of the Beneficial Owner Regulations relate to financing transactions (see alerts [here](#), [here](#) and [here](#)), they are broadly drafted and have clear implications for Indonesian equity investments as well.

This article reviews the application of the Beneficial Owner Regulations to equity investments, as well as the relative merits of Hong Kong and Singapore as an equity holding jurisdiction in light of the new Hong Kong-Indonesia double taxation treaty.


The Beneficial Owner Regulations

The Beneficial Owner Regulations set forth a series of objective criteria to determine whether foreign parties may benefit from a double tax treaty with Indonesia. These criteria establish whether the recipient is the ‘beneficial owner’ of income derived from Indonesia, at least as far as the Indonesian tax authorities are concerned. If the foreign party does not meet these criteria, it will not be entitled to double tax treaty benefits. Broadly speaking, the Beneficial Owner Regulations impose (i) substance requirements and (ii) anti-avoidance requirements.

(i) Substance Requirements

The foreign party must have an ‘active operation or business’ that demonstrates “*costs incurred, work applied or effort directly associated with the business operations or activities in order to obtain, collect and maintain income, including significant efforts to main the business continuity of the entity*”. It is not immediately apparent that all equity holding companies will meet these criteria.





It seems likely that a diversified holding company with subsidiaries in various jurisdictions and a real central management team will meet the substance requirements. However, the case of a single entity holding company is much less clear, particularly if interposed between substantive entities to gain tax treaty advantages. Single entity holding companies need to show substantive activities to meet the requirements under the Beneficial Ownership Regulations. While active management and control may be sufficient for these purposes, it is possible that the Beneficial Owner Regulations may require other activities to be conducted by the holding company.


(ii) Anti-avoidance requirements

The anti-avoidance requirements include a subjective criterion that “*the transaction itself is not structured solely to take advantage of the treaty benefits*”, as well as an objective criterion that “*fifty percent (50%) or more of the income is not used to satisfy an obligation to another party in the form of interest, royalty or other reward*”. This is intended to cover ‘pass-through’ entities that receive Indonesia sourced income subject to lower treaty withholding rates and immediately pay the income on to persons that would not otherwise be eligible for such rates².

The subjective criterion has implications for investments that interpose an equity holding company in a jurisdiction with a favourable double tax treaty with Indonesia for the purposes of a single investment. The second criterion has a more specific implication for tax structuring - that is, it creates an effective thin capitalization limit on a foreign equity holding company from the Indonesian perspective, independent from any thin capitalization rules in the holding company’s jurisdiction³. This requires careful consideration of the capitalization of equity holding companies, as well as a careful consideration of the capitalization of the Indonesian subsidiary.

(iii) Practical implications

Investors that have multiple equity holdings in Indonesia and wish to secure double tax treaty benefits should consider aggregating these holdings in a single equity holding vehicle to avoid criticism that their holding structures lack substance. A real centralization of management functions with a management team in the foreign jurisdiction is also advisable. In the case of private equity investors, one strategy might be to establish a Singapore or Hong Kong holding company (or sub-fund) that would hold all Indonesian investments, and to appoint real investment management at that level.



Another strategy to reduce risk on substance requirements may be to diversify the business of the equity holding company. For example, if the Indonesian company has offshore procurement, sales or trading operations, transferring these operations to the holding company should substantially reduce the risk of the latter company being deemed to have insufficient substance. However, this may not always be commercially appropriate in practice, and will also have tax implications which would need to be considered. We discuss some of these tax implications below.

Plans for a public offering of the equity holding vehicle should also be considered. An entity whose shares are publicly traded is *prima facie* treated as an entity of substance under the Beneficial Owner Regulations. Accordingly, if the investment strategy contemplates an initial public offering ‘exit’ or liquidity event in the future, the preferred choice of listing venue may be a driver behind the choice of jurisdiction. For an overview of a potential Hong Kong listing of Indonesian assets in a mining context, please see our article [here](#).

Preferred Jurisdiction for Equity Holding Companies

Assuming the Beneficial Ownership Regulation criteria can be met, the next question is the choice of the more favourable jurisdiction in which to organize and the operate equity holding vehicles. There are various factors which may influence the choice of holding company jurisdiction, including tax, the flexibility and stability of the relevant corporate law regime and the quality of local service providers. It is our experience that both Hong Kong and Singapore have world class legal systems as well as local services providers, and we do not see that either jurisdiction has a significant competitive advantage in this respect. However, one very practical consideration will be the presence of existing operations of the investor undertaking in one of these jurisdictions. It will clearly be far easier to satisfy the requirements of the Beneficial Ownership Regulation in a jurisdiction in which the investor already has operations.

In this article we review the relative merits of the tax regime in Singapore, one of the more common equity holding jurisdictions for Indonesian companies, against that in Hong Kong, on the assumption the new Hong Kong-Indonesia tax treaty, which was signed in March of this year, will be ratified and come into effect. Due to their geographic proximity, one expects that it should be relatively easy to establish real substance relevant to an Indonesian investment in either of these two jurisdictions. In addition, as each offers investment friendly domestic tax

regimes, we believe these two jurisdictions will continue to be highly relevant for Indonesian tax structuring.

For reasons of space, this article does not consider other possible investment holding jurisdictions with favourable tax treaties with Indonesia, such as The Netherlands, Seychelles and United Arab Emirates, although there may be good reasons to select such jurisdictions in appropriate cases - particularly for investors which already have substantive entities in these jurisdictions. On a case by case basis, it is also worth considering direct investment by an investor with substance in a high-tax jurisdiction, although this type of analysis is far beyond the scope of this article.

(i) Comparison of the Two Tax Treaties

The Indonesia-Singapore and Hong Kong-Indonesia double taxation treaties are broadly similar in respect of income provisions: both provide for a maximum withholding tax rate of 10% on interest payments generally, although the dividends and royalty withholding tax rate are 5% under the Hong Kong treaty against 10% under the Singapore treaty.

The material difference between the two treaties lies in the treatment of capital gains. Significantly, the Hong Kong treaty exempts capital gains on share sales from withholding tax in Indonesia, which is often a key advantage in a private equity context where the majority of profits are typically realised in the form of capital gains on a divestment of the investment assets. There is not an equivalent provision in the Singapore tax treaty, which means that sales of unlisted Indonesian shares will generally be subject to an Indonesian withholding tax of 5% of the purchase price, regardless of whether any actual gain is realized.

It should also be noted that Indonesia's 2008 Income Tax Law contains an anti-avoidance provision which would apply the 5% withholding tax to a sale of shares in 'a conduit company or special purpose company which is established or domiciled in tax haven countries', if a sale of the underlying Indonesian shares would be subject to withholding tax. There is no clear definition of what constitutes 'a conduit company or special purpose company' for this purpose, although the notes to the 2008 Income Law do contain an illustrative example⁴.

In addition, it is not clear that Singapore would be regarded as a 'tax haven country' for these purposes, and we are not aware of any cases in which the Indonesian authorities have applied

these rules to a Singapore company⁵. It is also arguable that a Singapore company that meets the requirements under the Beneficial Ownership Regulations should not be treated as a 'conduit company or special purpose company' for these purposes. However, given the general policy stance of the Indonesian tax authorities that Indonesian tax should not be capable of avoidance through the use of 'conduit companies', this does not seem a risk that can be entirely discounted. It is also consistent with recent precedents and policy in other Asian jurisdictions⁶.

In contrast, the anti-avoidance rules would not be expected to apply to a sale of shares in a Hong Kong holding company that satisfies the requirements of the Beneficial Owner Regulations, as a sale of the underlying shares would not be subject to Indonesian withholding tax under the Hong Kong-Indonesia tax treaty.

(ii) Comparison of the Domestic Tax Regimes

The headline rates of corporation tax in Singapore and Hong Kong are also similar. Singapore has a headline corporate tax rate of 17%, compared to the Hong Kong rate of 16.5% (or 15% for unincorporated business). However, by virtue of partial exemptions under the Singapore tax regime, the effective rate of tax in Singapore for profits up to SGD300,000 ranges between 4.25% and 8.36%. Furthermore, Singapore provides a number of incentive schemes which, where applicable, can reduce the headline corporate tax rate on qualifying activities to 5% or 10%, which do not have a functional equivalent in Hong Kong. Therefore, depending upon the typical annual profit level which is anticipated, and/or the nature of the company's activities, the effective rate of taxation imposed in Singapore can potentially be appreciably lower than in Hong Kong.

Profits arising to a pure equity holding company established in either Singapore or Hong Kong in respect of an Indonesian equity investment would not generally be expected to be subject to Singapore or Hong Kong taxation. Under the Hong Kong tax regime, foreign dividends and interest payments received by a Hong Kong holding company are generally outside the scope of Hong Kong corporation tax⁷, as are any capital gains arising to a Hong Kong company in respect of a disposal of Indonesian shares. In the case of Singapore, capital gains arising to a Singapore holding company in respect of a disposal of Indonesian shares will similarly be outside the scope of Singapore tax⁸. As regards foreign dividends, no Singapore tax will generally be imposed on dividend payments from Indonesia.



Finally, interest payments received by a Singapore holding company from Indonesia will be subject to tax in Singapore only if and to the extent they are remitted to Singapore, and even if such payments are remitted it is usually possible to capitalize the Singapore company in a manner that will utilize sufficient credits from tax withheld in Indonesia to ensure that no additional tax will be levied on interest payments in Singapore.

On the other hand, to the extent that the equity holding company engages in any business operations, either for the purposes of satisfying the Indonesian substance requirements or otherwise, any profits arising from such operations would generally be subject to taxation in Hong Kong or Singapore (as applicable). However, in most of such situations, these operations will not typically be expected to generate significant amounts of taxable profits, and provided such profits are not in excess of approximately SGD2m per annum, the partial exemptions under the Singapore tax regime will usually mean that a Singapore holding company will suffer less tax leakage than a Hong Kong holding company.

In terms of repatriating profits from the holding company back to the fund or ultimate investor, dividends can be paid from both a Singapore holding company and a Hong Kong holding company without any withholding in respect of Singapore or Hong Kong tax. However, while Hong Kong does not withhold tax on interest payments offshore, Singapore will generally withhold such tax at the rate of 15%, but this can often be mitigated either through exemptions under local rules (such as the qualified debt securities scheme), capital structuring or benefits provided under a relevant double tax treaty. In the event that an investment is realised through a disposal of shares at the holding company level, no local charge to tax or withholding should arise whether the holding company were a Singapore or Hong Kong holding company.

Conclusions

The choice between Singapore and Hong Kong is likely to be a difficult one. Singapore is likely to have a more favourable headline corporate tax rate for most equity holding vehicles - either due to low taxable incomes or concessionary tax regimes. However, the Hong Kong treaty does provide a very significant degree of additional flexibility due to the exemption from Indonesian capital gains withholding tax on a sale of Indonesian shares and

the related lower risk of being caught by the anti-avoidance rules discussed above. For example, a private equity investor may be able to aggregate all of its Indonesian holdings in a single Hong Kong entity managed by the core funds team for the purposes of meeting the requirements of the Beneficial Owner Regulations. This approach would not normally be efficient in the case of a Singapore company, as it would lead to a capital gains withholding tax on sale of individual holdings. Accordingly, while it should normally be possible to structure an efficient exit through Singapore, this may require significant additional structuring work as well as potential difficulties in meeting the requirements of the Beneficial Owner Regulations.

A competing factor - which is likely to be of relevance to strategic investors as well as multi-jurisdictional private equity deals - is that Singapore has a much more established tax treaty network. Accordingly, Singapore is currently likely to be more attractive for a regional holding company with investments not just in Indonesia, but also in other South and South-East Asian countries.

The new Hong-Kong Indonesia double taxation treaty will likely open up some interesting new structuring options for Indonesian equity investments, particularly for private equity investors. However, Singapore may also be attractive for many investments due to its low effective corporate tax rates and extensive tax treaty network. A final consideration is the extent to which the investor already has substantive operations in either jurisdiction - the ability to convincingly demonstrate compliance with the Beneficial Owner Regulations in either jurisdiction is likely to be a persuasive factor in the choice.

Endnotes

1. Revised as of April 30, 2010, Regulations [*citation*]
2. Confusingly, this was 'clarified' in the April 30 reissue of the regulations as follows: This criterion is met if not more than fifty percent (50%) of the foreign tax payer's ***total income***, of any type or from any sources, as disclosed in the unconsolidated financial statements of the foreign tax payer, is used to meet obligations to third parties (excluding business costs such as employees and operational expenses). Accordingly, even a very substantial entity might fall foul of these regulations if thinly capitalized.

3. It should be noted that this is not a pure thin capitalization test as other economic obligations of the holding company are also taken into account.

4. The example reads along the following lines (unofficial paraphrase):

Consider X Ltd, established and domiciled in tax haven country A, which holds 95% (ninety-five percent) shares of PT X, established and domiciled in Indonesia. X Ltd is fully owned by Y Co, a resident of country B, and established as a conduit company to hold the shares PT X.

If Y Co sells all of its shares of X Ltd to PT Z which is a resident taxpayer, this transaction would, from a formal legal standpoint, constitute a transfer of shares of a nonresident entity by a nonresident entity, which is not subject to Indonesian tax. However, under the anti-avoidance rules, this transaction will be deemed to be a transfer of shares of a resident entity by a nonresident entity, such that income derived from this transfer is subject to Income Tax (and particularly withholding tax) in Indonesia.

5. Although the comment has occasionally been made by Indonesian politicians in official debate.

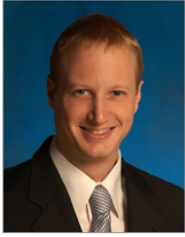
6. In a very high profile example, the Indian tax authorities regarded Vodafone's 2007 purchase of the Indian telecommunications assets of Hutchinson Whampoa through an offshore holding company as subject to Indian capital gains tax amounting to approximately Rp.112bn (US\$2.5bn). More recently, the PRC State Administration of Taxation passed Circular 698 (*Notice on Strengthening the Management of Enterprise Income Tax Collection of Proceeds from Equity Transfers by Non-resident Enterprises Guoshuihan [2009] 698*) to subject similar transactions to tax in the PRC. Circular 698 has reportedly already been used to levy PRC income tax on a divestment by an international private equity fund of PRC assets held through a Hong Kong holding company.

7. Most Indonesian equity holding companies will rely on a significant amount of shareholder loan capital, and this assumes that any interest income is not treated as Hong Kong source income for tax purposes. Under Hong Kong tax law, the 'source of income' with respect to interest is generally determined based on where the funds, from which the interest is derived, is provided to the borrower. In cases where the loans are not simple loans of money,

the source of interest income may be determined based on what the lender has done to earn the interest income at issue and where the lender has done it. Accordingly, there is a tension between the need to evidence real substance in Hong Kong for the purpose of satisfying the Beneficial Ownership Regulations and the need to conduct business activities related to the provision of credit outside of Hong Kong for the purposes of ensuring the interest income is not Hong Kong source income. A set of best practice procedures is likely to be to conduct non-administrative activities related to the provision of credit outside of Hong Kong (e.g., board meetings, investment decisions, negotiating and signing credit agreements and other related documents, etc.), while conducting as much of routine administrative activities as possible in Hong Kong. In addition, it may be possible to capitalise the Hong Kong entity in such a manner that the Hong Kong entity can take foreign tax credit and/or deduct any taxes withheld in Indonesia against its Hong Kong income.

8. This assumes that proceeds from the sale of shares in Singapore or Hong Kong are treated as capital gains and not as trading income for Singapore or Hong Kong income tax purposes. Whether proceeds should constitute capital gains rather than trading income will depend upon a number of factors, including, among others, the length of ownership of the relevant shares, the frequency of similar transactions being carried out, and the manner of financing the initial share purchase. No one factor will be definitive in every situation, and each case will depend upon its own particular set of facts. However, we understand the Singapore tax authorities have recently taken a more conservative position on this issue than previously, and some Singapore tax advisers now suggest that, where other factors are consistent with capital gains treatment, shares should still be held for at least 3-5 years before they are likely to qualify as capital gains. In the case of Hong Kong, this can also be mitigated by best practice procedures to ensure that all non-administrative activities (e.g., board meetings, investment decisions and document signing) take place outside of Hong Kong.

Contacts



Joel Hogarth
Singapore
+65-6593-1866
jhogarth@omm.com



Lawrence Sussman
Beijing
+86-10-6563-4205
lsussman@omm.com



Anita Choi
Hong Kong
+852-3512-2377
achoi@omm.com



Janice Seah
London
+44-20-7558-4846
jseah@omm.com



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Beijing

Yin Tai Centre, Office Tower, 37th Floor
No. 2 Jianguomenwai Ave.
Chao Yang District
Beijing 100022
People's Republic of China
+8610-6563-4200

Brussels

Blue Tower
Avenue Louise 326
1050 Brussels, Belgium
+32-2-642-4100

Century City

1999 Avenue of the Stars, 7th Floor
Los Angeles, CA 90067
+1-310-553-6700

Hong Kong

31st Floor, AIA Central
1 Connaught Road Central
Hong Kong S.A.R.
+852-3512-2300

London

Warwick Court
5 Paternoster Square
London, EC4M 7DX, England
+44-20-7088-0000

Los Angeles

400 South Hope Street
Los Angeles, CA 90071
+1-213-430-6000

New York

Times Square Tower
7 Times Square
New York, NY 10036
+1-212-326-2000

Newport Beach

610 Newport Center Drive, 17th Floor
Newport Beach, CA 92660
+1-949-760-9600

San Francisco

Two Embarcadero Center, 28th Floor
San Francisco, CA 94111
+1-415-984-8700

Shanghai

Plaza 66 Tower 1, 37th Floor
1266 Nanjing Road West
Shanghai 200040
People's Republic of China
+8621-2307-7000

Silicon Valley

2765 Sand Hill Road
Menlo Park, CA 94025
+1-650-473-2600

Singapore

9 Raffles Place
#22-01/02
Republic Plaza 1
Singapore 048619
+65-6593-1800

Tokyo

Meiji Yasuda Seimei Building
11th Floor
2-1-1, Marunouchi
Chiyoda-ku, Tokyo 100-0005,
Japan
+81-3-5293-2700

Washington, DC

1625 Eye Street, NW
Washington, DC 20006
+1-202-383-5300

www.omm.com