LAW PUNDITS

CHOOSING A HOLDING COMPANY JURISDICTION

Course Material

Choosing a holding company jurisdiction

Introduction

For businesses expanding internationally, an important consideration is the corporate holding structure for the business and the location of the entities used to own and operate the expanding business.

Many commercial factors are relevant to this issue, including the nature of the business and its customer base, the location of key management and employees and access to finance and other support services, but taxation and tax efficiency is often also a key consideration.

From a tax perspective, there are typically two main objectives for the holding structure of an international business:

1. minimising tax leakage on the distribution of profits and gains to shareholders and other beneficiaries, and
2. enhancing tax efficiency through the implementation of a holding structure that will deliver tax benefits for the business

For both of these objectives, the location of the underlying business activities, any holding company and the ultimate shareholders will be key. The location of the underlying business activities and the ultimate shareholders will usually be fixed or subject to commercial requirements, but there is often flexibility regarding the location of holding companies. This flexibility allows tax efficiency to be a relevant factor in the choice of holding company jurisdiction or indeed whether or not to utilise a holding company.

While tax efficiency is a factor in the use of holding companies, there are also sound business reasons such as consolidating management, ring fencing business divisions and administrative convenience.

Where holding companies are used, the company will typically own equity in subsidiary operating companies located in the jurisdictions in which the business operates (local

companies) or the assets of the business in those jurisdictions (Let's assume that the business will be operated through subsidiary companies). The profits and gains arising from the activities of the local companies will need to be passed up to through the holding company to the ultimate parent or other shareholders/beneficiaries of the business.

It is this flow of profits to, and investment from, shareholders where tax leakage can arise and also where opportunities exist to improve the tax efficiency of the arrangements through the use of holding companies.

Before undertaking any re-structuring of an international group of companies, the wider international tax context should be considered. This includes the OECD's ongoing initiative on Base Erosion and Profit Shifting (BEPS), upon which it published a fifteen point Action Plan in July 2013 and has subsequently various discussion drafts on specific actions.

Key attributes of a tax-efficient holding company

A. *Mitigation of local jurisdiction tax on payments to holding company*

Many jurisdictions impose withholding taxes or other similar source taxation on payments flowing out of the jurisdiction, such as payments of dividends, interest and royalties. Some jurisdictions also impose tax on gains made by non-resident shareholders on the disposal of interests in local companies.

Such withholding and other similar taxes are often reduced or removed under double taxation treaties or pursuant to multinational tax agreements such as the EU Parent-Subsidiary Directive and EU Interest and Royalties Directive.

Where withholding or similar taxes are applicable in the jurisdiction in which the local company operates, or may be a risk in the jurisdictions into which the business may expand, it is often tax efficient to utilise a holding company located in a jurisdiction with a

beneficial tax treaty or a wide tax treaty network, or a jurisdiction that is party to relevant multinational tax agreements.

There are however anti-avoidance rules, both domestic and included in tax treaties, that limit artificial 'treaty shopping'. Such anti-avoidance rules need to be considered carefully when analysing the tax treatment of a holding company structure, and it will often be necessary for a holding company to maintain a certain level of commercial substance in the holding company jurisdiction (such as human and technical resource, premises, bank accounts) to obtain the applicable tax benefits.

B. *No or low tax on payments received by the holding company*

A tax-efficient holding company will not be subject to tax on receipts from, or in connection with, local companies, or will only be subject to tax at a low rate. Alternatively, the tax rules of the holding company jurisdiction should facilitate structures to mitigate tax on receipts from local companies. Otherwise, tax leakage will arise on the flow of profits through the holding company to the ultimate shareholders/beneficiaries.

It may also be possible to use holding companies to reduce the effective rate of tax paid by ultimate shareholders/beneficiaries on the profits of the underlying business (when compared to the taxation of direct payments from the local companies to the shareholders), eg through the use of hybrid instruments converting interest payments to distributions.

More specifically, some or all of the following tax attributes should apply to a holding company in respect of payments received from or in respect of local companies:

1. no or a low rate of corporate income tax

2. exemptions (often known as participation exemptions) that reduce or remove tax on profit distributions from subsidiaries or on gains made on a disposal of subsidiaries.

3. tax deductibility for interest on external and internal debt finance (used to offset taxable income, such as interest payments on inter-company debt, received from local companies)

   Interest charged on loans from holding companies to local companies is often subject to corporate income tax in the jurisdiction of the holding company, at the applicable corporate income tax rate. This potential tax leakage can be mitigated through back-to-back interest-bearing loans from related or third party lenders. Provided the interest on these loans to the holding company is deductible for tax purposes, these deductions can be set against the interest earned by the holding company on loans to local companies, thereby reducing or removing tax leakage.

   Interest deductibility is also central to tax planning using hybrid instruments, meaning financing instruments that are treated as interest-bearing debt in the borrower jurisdiction but as equity in the lender jurisdiction. The objective of such arrangements is to obtain a tax benefit through a tax deduction for interest that is not matched by a taxable receipt of interest (since the receipt is treated as a distribution).

4. no or limited anti-avoidance rules targeted at attributing the profits and gains of local companies to the holding company (such as controlled foreign company (CFC) rules or transfer pricing rules)

Mitigation of holding jurisdiction tax on payments from holding company to shareholders

As with payments from local companies to a holding company, payments from the holding company to the ultimate shareholders/beneficiaries should not be subject to withholding or other taxation by the holding company jurisdiction. Again, any such taxation would constitute leakage from the flow of profits from the local companies to the ultimate shareholders/beneficiaries.

Consequently, a tax efficient holding company jurisdiction will not apply withholding tax to payments made to shareholders or other beneficiaries (eg dividends, interest and royalties). Alternatively, it will benefit from double tax treaties or multilateral treaties that reduce or remove withholding taxes on payments to the ultimate shareholders/beneficiaries.

Applicable anti-avoidance tax rules will again need to be considered.

Other relevant tax attributes

A tax efficient holding company jurisdiction may also have some or all of the following attributes:

1. a simple, stable tax code, to give comfort that a holding company structure is robust and not subject to sudden legislative change
2. established channels for taxpayers to engage with the tax authorities (to seek guidance, clearances or rulings), and
3. beneficial tax incentive regimes, for example research and development tax credits, patent or innovation boxes for intellectual property or sector specific incentives (such as incentives targeting the energy sector)