

European holding companies

A comparison of United Kingdom and other European countries' holding company regimes by Irfan Butt

Historically holding companies have been in existence for various reasons, e.g. legal, commercial and tax. Recently before the introduction of new double tax relief for companies United Kingdom (UK) multinational groups have held sub-groups under a sub-holding company located in a tax efficient jurisdiction, such as the Netherlands, which provided exemption from corporate tax on capital gains on the disposal of underlying subsidiaries and exemption from domestic taxation on the receipt of dividends from those subsidiaries.

The introduction of an exemption for gains arising on the disposal of substantial shareholdings from a charge to corporation tax may be tempting for a multinational to choose to locate its holding or sub-holding company in the UK. In reality, the introduction of the substantial shareholdings regime has given a competitive edge to the UK as a preferred location for the establishment of a holding company.

However, the recent changes to the UK's double tax relief (DTR) rules in certain circumstances make it difficult to obtain relief for excess unrelieved foreign tax credits (EUFT) from high taxed dividends against low taxed qualifying foreign dividends (QFDs). Careful planning is thus needed if the income maximisation strategy of a multinational group is not to be frustrated by a possible charge to additional tax in the UK on foreign-dividend income.

The main purpose of this article is to identify and highlight differences between various European holding company regimes, and the criteria which any foreign multinational should apply to determine the most suitable location for its holding company. The article applies to multinationals as well as family managed groups of companies. However, additional tax implications may need to be considered for UK family-owned groups of companies, e.g. *Capital Gains Tax Act 1992* (TCGA 1992), s. 13.

The countries covered in this article are Austria, Belgium, Denmark, France, Ireland, Luxembourg, the Netherlands, Spain, Switzerland and the United Kingdom.

Non-tax considerations

The rate of tax which a holding company may have to pay may not be the sole reason to set up a holding company in a particular jurisdiction. There may be other non-tax considerations, for example:

- political stability to ensure certainty about future business plans;
- flexible company law;

- stable economic infrastructure;
- time zone;
- language and cultural differences;
- local accounting requirements and their conformity with international accounting standards; and
- human resources.

It is possible that commercial issues may outweigh the tax considerations of a multinational group in choosing the location of its holding company, e.g. where a group requires a certain level of commercial presence in a foreign country to penetrate into the local market. Therefore, the preferred location for a holding company may not be solely tax driven and it is always possible that a group's desire to locate its holding company may be for non-tax considerations.

Tax considerations

The major tax considerations in choosing a suitable European holding company jurisdiction may include the following:

- exemption from tax for the holding company on in-bound dividends from its participation in local and foreign subsidiaries;
- exemption from local tax on the realisation of capital gains from the sale of shares in subsidiaries;
- double tax treaty network;
- withholding tax on inward and outward dividends;
- withholding tax on interest;
- deductibility of borrowing costs;
- corporate and local tax rates in respect of other income;
- thin capitalisation and the ability to obtain interest deduction in full;
- existence of controlled foreign companies (CFCs) rules;
- existence of pre-transaction as opposed to post-transaction rulings regime; and
- any other taxes, e.g. capital or stamp duty.

I will now consider each of the above tax considerations in detail relative to locating a holding company in a particular jurisdiction in Europe.

Tax treatment of inward dividends

With the exception of Ireland and the UK, most European countries, subject to certain conditions, provide either full or partial exemption from local taxation in respect of dividends received by a holding company from its local and foreign subsidiaries. This means that no or partial liability to tax will arise on dividends received from subsidiaries and likewise no relief in respect of underlying and withholding taxes is allowed in the home country.

The UK and Irish tax position as we are aware is somewhat different and dividend income from foreign subsidiaries is liable to tax in both jurisdictions. However, DTR is available in the UK as well as in Ireland, subject to the holding of a qualifying interest, to the recipient company in the form of deduction or by way of credit in respect of underlying and withholding taxes paid on foreign dividends.

In the past, the taxation of foreign dividends coupled with taxation of gains arising on the sale shares held in subsidiaries, would have been a factor deterring a multi-national group from locating its holding company in the UK. With the introduction of an exemption for gains on the disposal of substantial shareholdings from a charge to corporation tax and the introduction of on-shore pooling, the UK is now in a competitive position with the preferred holding companies jurisdictions, such as the Netherlands.

If a multi-national group chooses to locate its holding or sub-holding company in the UK, it is possible that direct ownership of companies from the UK may prove advantageous, subject to CFC rules, where the group effective tax rate did not exceed the UK's main corporation tax rate, as no further liability to corporation tax may then arise in the UK on the receipt of foreign dividends. This is on the assumption that under the on-shore pooling rules any EUFT arising on high taxed dividends would be offset against corporation tax liability arising on low taxed QFDs.

CGT exemption – from sale of shares in subsidiaries

Subject to certain conditions, most European countries provide exemption from tax on the realisation of a gain from the sale of shares in a subsidiary. With effect from 1 April 2002, a gain arising on the sale by a UK company of a substantial interest in a qualifying subsidiary is not normally subject to UK corporation tax.

The exemption of gains on the sale of shares in qualifying subsidiaries from a charge to corporation tax creates a level playing field with the traditional European holding companies regimes such as the Netherlands, Denmark, Luxembourg and Switzerland. This change should now enable non-European multi-nationals to consider the UK as the prime location for locating their European holding company for maximisation of income and capital.

Double tax treaties

Most European countries have an extensive double tax treaty network. The provisions of treaties may vary from country to country, e.g. the dividend article of the new United Kingdom/United States (US) double tax treaty, which in most

cases, imposes a nil per cent withholding tax on US outward dividends to a quoted UK holding company. The position with unquoted companies receiving dividends from US subsidiaries is not quite so favourable, but following the signing of the July 2002 protocol, unquoted UK holding companies will now also qualify for the withholding tax exemption in most circumstances. The treaty is now expected to take effect from April 2003.

Other examples may include inclusion of certain provisions and articles such as tiebreaker clauses, non-existence of treaty shopping provisions, tax sparing relief, etc.

As a first step, among others, a multinational will need to consider whether or not a short-listed preferred location for its holding company has concluded comprehensive double tax treaties with the relevant countries in which the profitable subsidiaries of the group are located. Careful tax planning is needed to ensure there are no unexpected surprises.

In view of the fact that the UK has concluded a large number of double tax treaties with other countries, the establishment of a UK holding company provides access to treaty benefits to the residents of jurisdictions such as Guernsey, Jersey, the Isle of Man and some other small former British dependent territories. Thus, the extensive double tax treaty network does give an edge over the other European Holding company regimes, such as the Netherlands, Denmark and Luxembourg, whose treaty network, especially in the case of Luxembourg, is not so wide.

Withholding tax on inward and outward dividends

Withholding tax on inward and outward dividends is an additional cost for the ultimate shareholder, i.e. the ultimate parent company of a sub-holding company. Withholding tax on outward and inward dividends reduces the net cashflow and may also affect the long-term investment objectives of the parent company.

The multinational groups may prefer to locate their sub-European holding company in a European jurisdiction which does not impose any withholding tax on outward dividends or a lower rate of withholding tax under the provisions of a relevant double tax treaty.

Most European countries excluding the UK impose a withholding tax on outward dividends. However, a lower withholding tax rate may apply depending on the resident of the recipient company and the existence of a double tax treaty between the payer and payee countries.

Although foreign dividends received by a UK parent company are subject to tax, under UK domestic law, there is no requirement to withhold tax on the payment of dividends to either UK or non-resident companies or individuals. Careful corporate tax planning can reduce any further corporation tax arising in the UK on foreign dividends and thus maximise the income stream for the ultimate foreign parent company.

Regarding withholding tax on inward dividends, the EC Parent Subsidiary Directive applies across the whole European Community. Therefore, where the interest held by a European parent company in a subsidiary located in another member state amounts to 25 per cent or more, the member state in which the payer is located does not impose any withholding tax on the payment of dividends.

Care must be taken to ensure that domestic anti-avoidance provisions of the payer's country do not prevent the application of the EC directive. Such situations are likely to arise where the ultimate beneficial owner of dividends is resident in a tax haven or the arrangement takes the form of treaty shopping.

Withholding tax on interest

In general, Denmark, Germany, the Netherlands, Luxembourg and Sweden do not impose withholding tax on outward interest, irrespective of where the lender is tax resident.

Domestic law in the UK does not provide exemption from withholding tax on UK source interest; however, a lower withholding tax rate may apply as specified in a particular double tax treaty. In general, a UK payer is required to withhold 20 per cent tax when making interest payments to a non-resident lender. This treatment only applies to UK source interest and not to non-UK source interest.

The existence of this withholding tax on interest (although it has to be noted that many of the UK's treaties provide for a zero rate) may be a deterrent for a multinational considering the UK as its holding company location, and cause it to channel its financing activities away from the UK. It may be possible to reduce the adverse tax implications depending on the world-wide activities of the group and the residence of the ultimate parent company.

Interest deduction for borrowing costs

It is important for the investor to obtain a tax deduction in respect of borrowing costs incurred in relation to investments in subsidiaries. A tax deduction in respect of interest will certainly reduce the tax rate of the holding company, assuming it carries on other activities against which such costs could be offset.

With the exception of Austria and the Netherlands, the other European jurisdictions as stipulated in the table, will allow a deduction in respect of the interest paid on borrowings to finance the acquisition of subsidiaries. In general, the UK allows for borrowing costs as long as the loan relationships anti-avoidance provisions do not apply to deny the recognition of interest as a non-trading loan relationship debit.

The Netherlands only allows interest deduction in respect of interest paid on borrowings to acquire local subsidiaries. This treatment does not extend to foreign subsidiaries or participations. However, this treatment has now been challenged and a case has been taken to the European Court of Justice (ECJ) on the basis that this treatment conflicts with community law. If the ECJ rules in the taxpayer's favour, as is likely now that the Advocate-General has given his opinion that the Netherlands is in breach of the EC treaty in this respect it will create a level playing field for the Netherlands holding company.

Tax rates

One of the major tax considerations is to locate the European holding company in a tax jurisdiction which does not impose any tax at all or at a low rate.

It is possible that in most cases, the income of a holding company may only consist of dividend income from local and

foreign subsidiaries and gains realised on the sale of shares in subsidiaries.

As discussed above, subject to various conditions, most European jurisdictions provide either full or partial exemption from tax on gains and dividends, therefore, the rate of tax may not always be an important consideration in choosing a preferred location for a European holding company. This may become important where the holding company also acts as a group finance company, i.e. where it lends surplus cash to companies in the group.

In such a case, a group may prefer to establish its holding company in a jurisdiction that imposes a low level of tax on passive income such as interest. In view of the advance ruling arrangements, jurisdictions such as the Netherlands, Luxembourg and Switzerland are considered the most attractive locations to carry on hybrid activities as the tax base can be negotiated with their tax authorities.

Thin capitalisation

Thin capitalisation may be a critical issue and it will be highly pertinent if the European holding company is thinly capitalised by its ultimate parent company. With the exception of Austria and Ireland most European countries have thin capitalisation rules to protect their tax base.

If a company is thinly capitalised, subject to thin capitalisation rules of the country in which the thinly capitalised company is tax resident, part of the interest deduction may be disallowed and treated as a dividend distribution.

Most European countries have safe harbour rules to determine whether a company is thinly capitalised. The UK's thin capitalisation safe harbour rules are not contained in statute. The Inland Revenue have set out general guidelines which may vary depending on the circumstances of each case, e.g. a debt to equity ratio of 1:1 and an interest cover of 3:1, may be acceptable. The UK domestic law provisions contained within *Income and Corporation Taxes Act 1988*, s. 209 may also bite, as most UK double tax treaties do not prevent the application of these provisions.

Pre-transaction rulings

Some European countries, such as Belgium, Denmark, the Netherlands, and Switzerland have a system of binding pre-transaction rulings. A pre-transaction ruling in respect of a particular type of transaction serves to remove taxation uncertainties in a particular jurisdiction.

The absence of a pre-transaction ruling system in the UK creates unwelcome uncertainty and makes it impossible for foreign companies in undertaking certain types of transactions where the taxation implications of those transactions are unknown or uncertain. Therefore, this is clearly disadvantageous for a UK holding company, in particular, where the holding company undertakes other activities, e.g. acting as a group financing vehicle, since there is no opportunity, as there is in other European jurisdictions, to agree a lower tax base in advance under a pre-transaction ruling system.

Controlled foreign companies

Denmark, Germany, France, Spain and the UK have CFC legislation to protect their tax bases. Under the CFC rules income and sometimes capital gains of the subsidiary or sub-

holding company may be appropriated to the parent company. Certain exemptions from the CFC rules may provide exemption from tax on the income of a CFC resident in certain jurisdictions. The UK has an Excluded Countries List which ensures that companies located in any of those countries are not subject to CFC legislation. Most recently, under the new powers granted to the Board of Inland Revenue, the Republic of Ireland has been removed from the Excluded Countries List. Due to a very low Irish corporation tax rate, unless the motive test or other exemptions are satisfied, the profits of the Irish subsidiaries will be brought into charge to UK corporation tax under the CFC legislation. However, capital gains remain outside the CFC regime, so, subject to any charge on closely held companies under *Taxes of Chargeable Gains Act 1992* (TCGA 1992), s. 13 such gains will be only be taxed on the UK parent company when these are distributed in the form of dividends.

Capital or stamp duty

With the exception of Denmark, most European countries levy capital or stamp duty on capital transactions. In the UK, no stamp duty is payable on the issue of new shares and ad valorem duty is only payable on the purchase of shares from

existing shareholders. Certain reorganisation and inter-company transaction exemptions may prevent a charge to capital or stamp duty.

Conclusion

With the introduction of substantial shareholdings exemption legislation coupled with no withholding tax on outward dividends and the ability to deduct borrowing costs by a UK company, the UK has certainly joined the race to be a major contender for locating a holding company. However, the non-existence of a pre-transaction ruling system coupled with complex CFC legislation and DTR rules may still deter a multinational company from establishing a UK holding company.

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