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THE HOLDING COMPANY - ANOTHER VISIT

Milton Grundy[1]

I last contributed a piece on this topic in 1997.[2] This "revisited" the subject-matter of my 1993 article[3]. Such proximity of dates suggests many and rapid changes in the law. This has not happened (though there have been a few changes); rather, there has been a change in "atmosphere", and a growth in opportunities for the zero-tax investor to make a direct investment in a high-tax country through the medium of a holding company.

In 1997, I devoted considerable space to Madeira and Malta. Nothing of substance has changed there, but the change of atmosphere has affected local sentiment and policy in both those territories is to adopt a "low profile" until the attitude of the European Union to their offshore facilities has clarified. The Trieste offshore centre has yet to see the light of day, and the Canary Islands regime has proved not to offer holding companies (though there is a capital duty advantage in incorporating a Spanish ETVE in the Canaries). But one may also discern a more general atmospheric change. A flurry of *Reports* (OECD, April 1998 and November 1999; G7, May 1998; UN, June 1998 and March 1999; Edwards, December 1998; UK - on Overseas Territories, March 1999; and the European Union, November 1998) has generated, or perhaps simply reflected, an atmosphere of prevailing hostility to tax avoidance and evasion (the distinction not being very scrupulously observed) effected by cross-border transactions of various kinds. And - no doubt in consequence - one senses at the present time a certain caution in the international tax planning area, a reluctance to embark upon any tax-reduction strategy - of a long-term kind at least, until the situation

1 Milton Grundy, Gray's Inn Tax Chambers, Gray's Inn, London WC1R 5JA. Tel: (020) 7242 2642. Fax: (020) 7831 9017. Member of the Editorial Board of this *Review*.

2 Under the title *The European Holding Company, Revisited*. 7 OTPR 147.

3 3 OTPR 171.

is clarified. At the same time, the spread of controlled foreign company legislation (now to be found in e.g. Australia[4], Canada[5], France[6], Germany[7], Spain[8], the United Kingdom[9] and the United States[10]) has restricted the use of holding companies by parent companies established in high-tax countries[11]. What position the OECD, G7, UN and United Kingdom will ultimately take, is not yet known, but the Report[12] of the European Code of Conduct Group, while hostile to the flow of untaxed income into a high-tax country without a tax charge, does not appear to be critical of the use of a holding company when the income flow is in the opposite direction. Paragraph 48 reads as follows.

> The Group considered a number of measures that exempt dividends received from subsidiary companies. These measures are often referred to as participation exemptions. The Group has given a positive evaluation [i.e. *disapproves of*] to measures that allow the exemption of foreign source dividends in circumstances in which the profits giving rise to the dividends have been taxed at a significantly lower level in the source country than they would have been if they had arisen in the Member State. Such measures allow income from tax havens and other harmful regimes to be received tax-free in the Member State ...

In the light of that not altogether discouraging comment, one may feel that the change of "atmosphere" in international tax planning need not inhibit the use of the holding company by an investor not subject to local tax on foreign income, planning to acquire a significant shareholding in an operating company located in a high-tax country.

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4 From 1st July 1990.

5 ITA, s.95.

6 CGI, Art.209B.

7 AstG, Para.7/14.

8 Law 42/94.

9 ICTA 1988 Pt.XVII Ch.4.

10 IRC s.951.

11 And see the "anti-mixer" provisions in the UK Finance Bill.

12 23rd November 1999.

The investor may be free of local tax for any one of several reasons. The investment may be made by a company or trust established in a jurisdiction which imposes no tax – e.g. Bermuda. The investor may enjoy a special exemption – e.g. as an international trust in Barbados[13]. Or the investor may be an individual resident in a jurisdiction which imposes no tax on foreign income, like Hong Kong[14] or a non-domiciled individual resident in a country with a "remittance basis"[15]. Whatever the reason for the investor's freedom from local tax, and whatever form the investing entity may take, the investor will be referred to here simply as the "zero-tax investor". The question to be examined is, whether the zero-tax investor should invest directly into the operating company or should interpose a holding company established in a third country, and if so in which country.

What the zero-tax investor needs from a holding company is essentially three things. First, it needs the holding company to be able to get dividends out of the operating company free of withholding tax or at a lower rate of withholding tax, by virtue of a tax treaty or under the European Union Parent/Subsidiary Directive, and to be able to dispose of its investment in the operating company without any liability to capital gains tax or its equivalent in the operating country. Secondly, it needs to see some provision in the domestic laws of the holding company jurisdiction which wholly or largely exempts such dividends and capital gains from local tax. And thirdly, it wants to have the ability – and this, traditionally, has been the most difficult step – to take dividends out of the holding company without giving rise to any charge to tax in the holding company jurisdiction.[16]

Several continental European countries apply the *non bis in idem* doctrine to incoming dividends: if they are paid out of profits which have suffered tax elsewhere, they should not be taxed again in the hands of the recipient. This is the classic "participation privilege", and here the Netherlands is undoubtedly pre-eminent: the Dutch holding company has been around for a long time, so there are plenty of people in Holland – both in private practice and in the tax department – who understand how it works and have a great deal of expertise in dealing with international transactions of all kinds. It is, moreover, an important

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13 International Trusts Act, 1995.

14 IRO s.14.

15 E.g. Barbados, British Virgin Islands, Ireland, Singapore, United Kingdom.

16 See *The Holding Company and the Zero-tax Investor* edited by the author (The International Tax Planning Association, 2000). Material in this article is derived from the author's address to the Association in Amsterdam in May 2000 and from information contained in this book.

advantage of the Netherlands that it has a very large network of tax treaties, as well as having the benefit of the European Union Parent/Subsidiary Directive. There is a similar regime in Denmark and Luxembourg. The regime in Belgium is somewhat similar, but it offers only a 95% exemption, leaving 5% of dividends subject to tax. However, Belgium does not in principle apply debt/equity ratio rules in respect of thin capitalisation of a company, so that if there is enough interest flowing out of the holding company to absorb the remaining 5% of the income, there will be no tax liability in Belgium.

But the difficulties come with the next step - taking the untaxed income out of the holding company and putting it into the hands of the zero-tax investor. The Netherlands imposes a 35% tax on outgoing dividends, and it is in the avoidance of this tax that zero-tax investors have displayed much of their ingenuity. The classic solution to the problem continues to be the interposition of a "super-holding" company in the Netherlands Antilles. The rules have changed considerably since 1993, and not all of the changes have yet been completed, but it is generally foreseen that a dividend from a Dutch holding company up to the zero-tax investor via the Antilles will cost tax of the order of 10%, although it will still be possible to reduce this figure considerably by capitalising the Dutch and the Antilles companies heavily with debt. Denmark has recently abolished its withholding tax on outgoing dividends[17]. This opens up the possibility of using Denmark for the "super-holding" company to take dividends out of the Netherlands, or out of Belgium or Luxembourg (each of which would impose withholding tax on dividends flowing directly to the zero-tax investor), or indeed of using Denmark in place of Belgium, Luxembourg or the Netherlands. It is a feature of the tax regimes in Belgium and Luxembourg (which in this respect are different from the Netherlands) that no tax is imposed on distributions on a liquidation, and in Luxembourg it is even possible to liquidate a company by degrees - so to speak, where shares of a certain class may be redeemed without affecting shares of another class. The need for any form of liquidation - and the need for a "super-holding" company can be postponed, sometimes for very many years, by repaying debt (and by creating a class of non-interest-bearing debt intended to be repaid in this way).

There are other countries which host holding companies by having a low-tax regime applicable to a category of "offshore companies". Cyprus is a jurisdiction well-established in this field, particularly for investments in Eastern Europe. The rate of tax paid by an "offshore" company is 4.25%, but credit is given for foreign tax suffered on incoming dividends (and a tax-sparing credit is provided

17 Act No.1026 of 23rd December 1998.

by the treaty with India) which in many cases wipes out the tax liability altogether. Hungary also offers a low-tax regime: its special advantages are its location in Eastern Europe and its very old-fashioned treaty with the United States, but unfortunately it levies tax on outgoing dividends, and it is therefore necessary for the zero-tax investor to interpose a "super-holding" company in Cyprus or Denmark, so as to reduce the Hungarian withholding tax to 5%.

In 1993 and 1997, I wrote about the *European* holding company. The zero-tax investor can now look further afield - to Malaysia, Mauritius and Singapore. Since the beginning of 1998, Malaysian companies have been exempted from tax on foreign-source income, whether remitted to Malaysia or not, and foreign income exempted in this way may be distributed as a dividend, without the imposition of Malaysian tax[18]. And Mauritius has become an interesting site for a holding company, not because it offers any special low rate of tax to "treaty shopping" companies, but because it applies what could euphemistically be described as a generous credit for foreign taxes. It has a corporate tax rate of 15%, and a company will get the usual credit for actual tax suffered on foreign income. But it can alternatively have a credit for notional foreign tax, and the effect of this is to bring the tax rate down from 15% to 1.5%.[19]

Lastly, there are two countries which can serve as a base for a holding company, on the grounds that the tax system offers credit for underlying tax suffered by the operating company, sufficient to absorb the local tax, and impose no withholding tax on outgoing dividends. These countries are Singapore and the United Kingdom, which have corporate tax rates of 26% and 30% respectively. Singapore has one or two places on its list of treaty partners which are not to be found elsewhere; the United Kingdom, of course, has a huge network of tax treaties, the current treaty with the United States being especially favourable in this context. Readers of my 1997 article can now forget what I said about the UK International Holding Company[20]. But one still has to bear in mind that the United Kingdom offers no exemption for tax on capital gains. The zero-tax investor can dispose of shares in the UK holding company without incurring any

18 Income Tax (Exemption) (No.48) Order, 1997.

19 Income Tax (Foreign Credit) Regulations, as amended, 1997.

20 Finance Act 1998, s.31.

tax charge in the United Kingdom,[21] but if it is contemplated that the US operating company will be sold, an appropriate structure will need to be put in place in the beginning - e.g. by vesting the shares in a UK trustee on trust to pay the income to the holding company, or dividing the capital of the US operating company into shares of two classes.

I warned the Dear Reader of my 1997 article to expect changes in this area. It is a warning I feel duty-bound to repeat ...

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21 This freedom from tax on capital gains, and the freedom from tax on dividends paid to non-residents (Finance Act 1995 s.128) means that a zero-tax company needs no holding company to invest in the United Kingdom, but individuals and trusts will commonly interpose a holding company as a shield against UK inheritance tax.