INTERNATIONAL HOLDING COMPANIES

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Overview

Once a group of companies includes subsidiaries located in different jurisdictions there will be an inevitable focus on grouping foreign subsidiaries under an international holding company. The policy is frequently driven by commercial, as well as tax, considerations. This may result in a series of regional international holding companies.

Potential business benefits include:

- A packaged vehicle to facilitate a public offering, new investors, or ultimate sale.
- A clear business structure with defined responsibilities for results.
- Enhanced motivation of senior personnel.
- Freer ability to retain and reinvest foreign earnings.
- Separation of liabilities and risks.
- Streamlined integration of new acquisitions.

The main tax benefits and features to be expected are;

- A participation exemption for dividends and gains.
- A wide treaty network.

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- Low or no withholding taxes on outbound dividends.
- Ability to file consolidated tax returns.
- Absence of CFC rules.

Tax benefits may therefore be gained when the group's home jurisdiction does not offer these features, or offers them on a less attractive basis. So it would be natural, for example, for a US company to consider utilising an international holding company for ownership of its foreign subsidiaries since the US itself does not offer a participation exemption.

Many jurisdictions now offer a participation exemption and are constantly widening their tax treaty networks. This may result in less demand for groups to incorporate a separate international holding company. Nevertheless, business requirements and tailored tax solutions are bound to keep this vehicle on the agenda for the foreseeable future.

Introduction

The information in this paper is subject to local review in each relevant jurisdiction.

Before discussing the features and benefits of an IHC it is necessary to deal with a two factors common to the incorporation of all foreign subsidiaries; namely, capitalisation and corporate residence.

Capitalisation

Many IHC's do not incur tax liabilities in their own jurisdiction since income will primarily consist of tax-free participation exemption dividends and gains. As a result the IHC could be entirely capitalised with equity, leaving any debt obligations to be incurred by other group companies with tax exposure that could be reduced by debt interest.

However there may be circumstances where debt capitalisation is advisable for offsetting interest payments against taxable income. For example the IHC may receive taxable interest or royalties. Or it may make an acquisition in its own jurisdiction where its interest payments could offset profits of the acquired subsidiary in a consolidated tax return. In a few cases it might even be able to consolidate its interest payments against profits of foreign subsidiaries under specific conditions, e.g., in **Austria, Denmark and Italy**.

Stamp taxes and fees may be payable on the issue of IHC's equity and debt.

Corporate residence

It will be necessary to ensure that the **IHC** is tax-resident in its selected jurisdiction. Tax residence elsewhere may result in the complications of dual residence and tax exposure.

Most jurisdictions regard a company as a resident if it is either incorporated, or effectively managed, in the jurisdiction. There is therefore a risk that an IHC, although incorporated in its own jurisdiction, may be effectively managed in a jurisdiction that exposes its income and gains to substantial tax liabilities.

Broadly speaking effective management envisages that key management and commercial decisions, normally taken at board of director level, will be made in the IHC's jurisdiction.

In order to rebut any assertion that the IHC is resident elsewhere, it will therefore be essential that IHC decisions (supported by documentary evidence) are taken in its own jurisdiction. Typical decisions will relate to matters such as: issue of shares and debt; borrowings; acquisitions and disposals; monitoring, capitalising and lending to subsidiaries; investment and reinvestment of funds.

A board of directors is required that is suitably qualified to make such decisions on a regular basis in the IHC's jurisdiction.

Ideally, therefore, the IHC could be located in a jurisdiction where the group already has trading operations. For example a Danish trading subsidiary could also take on the IHC functions. Or a separate Danish IHC could be incorporated for this purpose with a board of directors that includes individuals on the board of the trading subsidiary, with meetings held at its premises.

Various detailed factors relevant to corporate residence are outside the scope of this paper; such as differences between effective management and central management and control, electronic attendance at board meetings, dual residence and Mutual Agreement Procedures.

Relevant Factors

Dividends received

In some IHC's the participation exemption will be denied if, in the subsidiary's jurisdiction, the dividend payment is tax-deductible e.g., **Denmark, Italy, UK**; the subsidiary carries on a passive activity; or it is resident in a blacklisted or low-tax jurisdiction.

Capital Gains

Similar restrictions may deny a participation exemption for capital gains

Dividends paid

Some countries, such as **Cyprus, Hong Kong, Malta, Singapore and UK**, impose no withholding tax on outbound dividends.

Withholding tax may be nil under the EC Parent/Subsidiary Directive which also extends to **Switzerland**.

Some countries, such as **Denmark, Ireland and Luxembourg**, permit a 0% withholding rate to recipients in treaty partner countries irrespective of the specific treaty rate.

Malta provides for the dividend recipient to receive a substantial tax credit refund, irrespective of its country of residence.

Liquidation distributions

Although **Austria and Luxembourg** impose withholding tax on dividend payments, they do not impose it on liquidation distributions.

Interest paid

Debt/ Equity, Interest Capping and EBITDA restrictions are widely applicable.

Some countries, such as **Luxembourg and Singapore**, deny interest deductions to the extent the paying company benefits from the receipt of tax-free dividends and gains. As from 1 January next, **Netherlands** is introducing rules that limit deductions by reference to its participation exemption.

In some countries deductions are denied if the interest relates to IHC borrowings for acquisitions from fellow group members. This would be relevant when an IHC acquires a FC Subsidiary from a group member, financed with borrowed funds. Examples of jurisdictions imposing these restrictions are: **Austria, Canada, France, Ireland, Netherlands, Spain, and Sweden**. There is an increasing trend for this type of anti-avoidance ('anti-share dumping') rule.

In general there is an increasing trend to limit interest deductions, in particular if they relate to connected party borrowings or acquisitions, or if they can be related to exempt income or gains, or if paid to a hybrid entity.

Deducting the interest

The interest may be deductible against the IHC's own taxable income such as interest, royalties, or possibly trading profits.

However the IHC may have no taxable income of its own, which could be confined to participation exemption dividends and gains.

In that case the IHC's interest costs might be deductible against taxable income of local subsidiaries in a consolidated tax return.

Where the IHC's jurisdiction does not provide for consolidated returns eg, **Belgium or Canada**, it may be possible to carry out a tax-free merger so that the IHC becomes entitled to the ongoing taxable income that formerly accrued to the merged subsidiaries.

A few jurisdictions permit cross border consolidation, in which case it might be possible to then deduct the interest from the profits of the target or other foreign subsidiaries. Examples of jurisdictions permitting international consolidation under specific conditions are: **Austria, Denmark and Italy.**

CFC exposure

CFC rules may apply in the IHC's territory but in many cases its foreign subsidiaries will be carrying on active businesses whose profits are unlikely to be subject to CFC apportionment.

The IHC's income may also be vulnerable to CFC apportionment in its ultimate parent company, especially as the income will consist primarily of dividends received by the IHC. However these dividends will not be apportionable if they qualify for a participation exemption in the parent company jurisdiction. And even if this does not apply, CFC apportionment may not be relevant if the IHC's dividends are received from its active trading subsidiaries.

Transferring subsidiaries to the IHC

The IHC may be acquiring subsidiaries from other group members.

In many cases a participation exemption should make it possible to transfer the subsidiary's shares to the IHC without incurring tax in the transferor's jurisdiction.

But failing this, a taxable gain may be avoidable by issuing shares in the IHC in exchange for the shares of the subsidiary that it acquires. This is mandatory between EU companies as a result of the EC Merger Directive and is also a feature of tax legislation in other countries.

A tax-free share exchange will generally be inapplicable if tax avoidance is one of the principal objectives of the share exchange. In some jurisdictions, prior clearance may be obtainable from the tax authorities in the transferor's jurisdiction.

Tax liability may also arise on a source basis in the jurisdiction of residence of the foreign subsidiary whose shares are being transferred. In many cases there will be no liability under its domestic legislation. But if it there is, it is likely to be exonerated under a double tax treaty between the respective jurisdictions of the transferor and transferee, based on *OECD Model Article 13.5*.

However a number of jurisdictions tend to reserve taxing rights over non-residents' transfers of subsidiaries in their jurisdiction, typically **China and India**.

And, depending on the specifics, the gain on transfer may not be treaty-protected if the transferred subsidiary is a company whose main assets are real estate located in its jurisdiction.

Transfer taxes

Finally, stamp or transfer taxes may be payable on IHC's acquisition of the FC Subsidiary.

Conclusion

With businesses of all sizes inevitably involved in cross border activities, international holding companies will remain as an important focus on their agenda.

There is a wide selection of suitable locations available across the globe but each situation needs tailoring according to profile and needs.