THE EUROPEAN HOLDING COMPANY

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Ownership of shares in companies operating in various countries may be concentrated in a single holding company for a variety of reasons, not only or solely fiscal - for historical reasons in some cases, or in others for the purpose of enabling assets and income to be consolidated. Or a group operating in countries perceived as politically unstable may establish a holding company in a politically more acceptable jurisdiction.

But the decisions, whether or not to establish a holding company, and if so in what jurisdiction, will in general be largely influenced by tax considerations. These may come in many forms. If the investing company is located in a high-tax country, the rules relating to controlled foreign companies and credits for foreign taxes may be of paramount importance. But in order to focus on the tax effect of the holding company itself it is perhaps convenient to postulate an investor with no such preoccupations - e.g., an individual living in Monte Carlo, or a trust established in the Cayman Islands.

The needs of such an investor may be well met simply by the formation of a holding company in a zero-tax jurisdiction. In this context, nothing really turns on which zero-tax jurisdiction is chosen. But if a quotation on a stock exchange is envisaged, Bermuda may be a first choice, simply on the grounds that a number of Bermudian companies are already listed. There seems no reason in theory, however, why other zero-tax jurisdictions should not be utilised in the same way and indeed it is understood that some BVI companies are quoted on exchanges in Canada.

When it comes to investing within the European Community, a holding company in the EC is to be preferred, if only in order to reduce the level of investigative attention to which the operating companies may suffer at the hands of their respective tax authorities. It has been for years broadly accepted that the alternatives were the Luxembourg company established under the 1929 legislation ("a 1929 Luxembourg holding company") and the Netherlands company enjoying the participation privilege - the latter being appropriate where treaty benefit was required, the former when it was not. Switzerland presented itself for a time as

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a third possible jurisdiction, but the Swiss holding company has the well-recognised disadvantage of the 35% Federal tax on distributions, and once it became clear that Bern was determined to put obstacles in the way of a Swiss holding company using the treaty with the Netherlands to avoid this tax, there seemed (in the kind of circumstance we are presently considering) no reason not to dispense with the Swiss company and have the interests in the operating companies held directly by the Netherlands company. Whether the Swiss authorities will take the same attitude to the use of the Swiss-Danish treaty is not clear; if that treaty can be used, dividends can pass without withholding tax to a Danish company; they will not be taxed in Denmark, and if the Danish company is thinly capitalised the bulk of them will be absorbed by outgoing interest.

A 1929 Luxembourg holding company suffers no tax on its income. Nor, strictly speaking, is there a tax on its distributions, but the company pays a capital tax which is effectively a 2% tax on distributions. In the Netherlands, no tax is charged on dividends or capital gains arising from a "qualifying participation". A qualifying participation, in general terms, is a holding in a company which is subject to tax (at whatever rate) in some country, where the holding involves some active participation in the affairs of the company and is not a mere passive investment. The requisite holding is, in law, a mere 5%, but it is understood that in practice the Dutch tax authorities may be unwilling to treat a holding of less than 50% as involving "active participation". Logically, expenses relating to a qualifying participation are not deductible.

Comparable facilities for holding companies are offered by other European countries - by Austria, Denmark and France, and now (with the introduction of the SOPAFI) by Luxembourg and (in Madeira) by Portugal as well as (when the EC Directive is modified) by Gibraltar. What all these jurisdictions essentially offer is no domestic tax on foreign dividends, and a lower rate of or exemption from foreign withholding tax on such dividends in accordance (except for Gibraltar) with the tax treaties to which they are respectively parties. In some cases they offer also treaty exemption from capital gains tax on any disposal of the holding in an underlying company (a tax *prima facie* payable in some countries even by non-residents - e.g., Germany and Spain). In addition to and quite separately from treaty benefits, taxpaying companies in the European Community are entitled under the EC Directive to dividends from "subsidiaries" in other EC countries without any withholding tax. A "subsidiary" is a company in which at least 25% of the equity is held by the recipient of the dividend. The Directive does not prevent the application of any domestic rules directed against fraud or abuse. A Madeira offshore company, being free of local tax, will not get the benefit of the Directive, though it does have the benefit of the Portuguese treaties. The 1992 Gibraltar holding company has no treaty benefit but is expected to get the benefit of the Directive in due course.

The Directive and treaty provide very straightforwardly for favourable treatment of dividends paid by the operating companies to the holding company. What is much less straightforward is achieving favourable treatment for the outgoing dividends of the holding company itself. For the Netherlands holding company, the structure classically adopted has been the superimposition of a Netherlands Antilles company. It costs a small Antilles tax, and nowadays it costs a small Dutch tax as well, to transfer income from the Netherlands company to the shareholder of the Antilles company: together the taxes amount to some 10% or 11%. This figure may be reduced considerably by capitalising the Netherlands company heavily with debt: interest may be paid out of the Netherlands company without withholding tax, and a debt/equity ratio of 85/15 will generally be tolerated by the Dutch tax authorities. If the Antilles company is also geared up in a similar way, the tax cost of passing dividend income from the operating companies through to the shareholder of the Antilles company (let us call it "throughput tax") can be reduced to a very low level.

Luxembourg also imposes no tax on outgoing interest, and the tax authorities there will tolerate a much higher debt/equity ratio than is permitted in the Netherlands; this can in an appropriate case reduce the throughput tax below Netherlands/Netherlands Antilles levels, even though Luxembourg has as yet no equivalent of the Antilles. Denmark has no interest withholding tax and no concept of debt/equity ratio, so higher gearing can make the Danish holding company route the lowest of all in throughput tax, even though as in Luxembourg any residual income distributed by way of dividend suffers the full rate of withholding tax.

Where the underlying activities of the group are not capital intensive, it can be difficult to provide enough debt to achieve any significant reduction in throughput tax. In such circumstances it is sometimes possible to create debt by selling one group company to another (and indeed a similar technique may reduce the taxable profits of the operating companies themselves). If such a transaction is contemplated, shares in one or more operating companies will first be vested in a zero-tax company. When they have risen in value, and before any dividend has been declared, they are sold to the intended holding company partly for equity and partly for loan. This technique may be applied to a holding company itself - e.g., by the sale of, say, all the shares in a Netherlands holding company to a Danish holding company, 1% of the price being satisfied by an issue of shares and the rest remaining outstanding and carrying interest.

But if the level of throughput tax remains unacceptably high, despite everything that can be done by way of interest charges, the possibility needs to be considered of vesting the holding company shares in a company which will benefit from treaty or Directive relief without itself being liable to any significant tax on incoming or outgoing dividends. When the Directive has been amended, Gibraltar will offer the most favourable regime within the Community. For treaty relief, a company in Malaysia benefiting from the advantages offered by Labuan reduces the throughput tax to 3% with a maximum of M$20,000 (approximately US$7,000)! Via Malta the throughput tax is about 6% and via Madeira 5%.