How to choose your holding company location

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There have been some significant recent international developments that may affect the attractiveness of different tax jurisdictions for locating a holding company. Whilst this is not a decision that is driven solely by tax, it is important to go back to the fundamentals and to apply these to the particular fact pattern of the group concerned. This is particularly so given the many recent changes to domestic tax regimes and the wider changes being imposed by initiatives such as the EU's Anti-Tax Avoidance Directives.

In any cross-border merger transaction, an early issue to consider ought to be where the holding company for the merged group should be located. This is not just a tax question - the location of the business, stock market requirements, political concerns, and practical issues for the management team all come into play - but tax can often be an important consideration.

As can be seen from the Tax Foundation's recently published International Tax Competitiveness Index 2019, there have been some significant developments in this area. For example, the implementation of the Anti-Tax Avoidance Directives within the EU has eliminated some of the distinctions between EU member states, such as whether they have transfer pricing rules or a controlled foreign company regime. In addition, since that survey was published, Ireland has increased the rate of withholding tax on dividends and the Netherlands has introduced a withholding tax on interest and royalties. This is indeed a fast-moving area.

This article looks at the fundamental tax issues which may affect where such a holding company might be established, or indeed where an existing holding company might migrate to.

Tax considerations

Withholding tax

One of the most important tax issues which is relevant when choosing the location of a holding company is the possibility of withholding taxes being levied on dividends. This is relevant both to dividends paid up to the holding company from the group's various operating subsidiaries, but also to dividends paid out by the holding company to the ultimate shareholders of the merged group.

The first of these issues can be significantly mitigated by locating the holding company in a jurisdiction with a strong network of tax treaties (and, within the EU, the benefit of the Parent-Subsidiary Directive). Traditional holding company jurisdictions such as Ireland, the Netherlands, and the UK all benefit from such networks. There are also some new kids on the block, such as Spain, where a new protocol to the US/Spanish tax treaty coming into effect on 27 November 2019 provides for a 0% withholding rate on dividends paid by 80% US owned subsidiaries.

Given the wide range of jurisdictions in which the shareholders of the holding company may be resident, the easiest way to address the second of these two issues is to locate the holding company in a jurisdiction which does not levy a withholding tax on dividends. Where a holding company is located in a jurisdiction which might require it to withhold on dividends paid out to certain shareholders, dividend access scheme arrangements (whereby dividends to participating shareholders are effectively paid by an underlying subsidiary based in a jurisdiction which does not levy a withholding tax on dividends) may be possible, depending on the shareholder base and the make-up of the underlying group, but such arrangements are costly and complex to administer. As such, jurisdictions which do not levy a withholding tax on dividends, such as the UK, remain popular choices. Both the Netherlands (which considered and then decided against abolishing its withholding tax on dividends in 2018) and Ireland (which announced, in the 2020 budget, an increase to its rate of dividend withholding tax from 20% to 25%) continue to impose a dividend withholding tax.

In addition to dividend withholding tax, the imposition of withholding taxes on interest and royalties was also taken into account in the Tax Foundation's tax competitiveness survey, and indeed resulted in the UK being ranked behind the Netherlands for withholding taxes, even though the UK (unlike the Netherlands) does not impose a dividend withholding tax. The survey might look a little different next year, as the Netherlands has recently announced that, from 2021, it will impose a 21.7% withholding tax on interest and royalties paid to related parties if they are resident in, or allocate the relevant payments to a permanent establishment in, a low-tax jurisdiction.

Headline corporate income tax rate

Despite the trend for governments to reduce their headline rates of corporate income tax, the rate of corporate income tax in any given jurisdiction is unlikely to be a significant distinguishing feature when deciding where to locate a holding company. This is because the majority of holding companies will not carry out any active business activities (in their jurisdiction of residence or elsewhere) to which corporate income tax would apply.

Instead, it is more important to consider whether the jurisdiction has a territorial basis of taxation, comprising (a) a tax exemption for dividend income received from subsidiaries, and (b) a tax exemption for capital gains arising on the sale of shares in subsidiaries.

Territorial basis of taxation and CFC rules

Controlled foreign company rules, introduced by higher-tax jurisdictions and designed to prevent the artificial diversion of profits to lower tax jurisdictions, are common features of many modern tax systems. Across the EU, the effect of Anti-Tax Avoidance Directives I and II has been to harmonise tax regimes, meaning that no EU regime can now claim not to have such a set of rules, and outside the EU many developed tax systems have also enacted equivalent provisions. However, the scope and extent of such rules play a crucial role (when combined with other aspects of any tax system) in determining where on the scale of territorial vs worldwide basis of taxation a particular jurisdiction sits and, perhaps even more importantly, where on that scale business perceives each jurisdiction's tax system to sit.

The effect of the UK's programme of corporate income tax reform between 2012 and 2014 (which included significant changes to the UK's CFC regime) provides a stark illustration of the importance of this issue to the choice of where to locate a holding company. In the years running up to 2012, a number of traditionally UK-headed firms – including WPP, United Business Media, Informa and Brit Insurance – left the UK. However, following this period of corporate income tax reform, the tide of such migrations from the UK was largely stemmed, and many of the companies that had left subsequently returned (see this HM Treasury presentation).

Exemption for dividend income received from subsidiaries

A tax exemption for dividend income received from subsidiaries, no matter where those subsidiaries are located, is a significant distinguishing feature when deciding where to locate a holding company. Although many jurisdictions provide for an exemption for dividends received from subsidiaries located within the same jurisdiction as the recipient, fewer allow for a complete exemption no matter the location of the payer of the dividend. In addition to those jurisdictions in which there is little or no corporate income tax to begin with, the UK and Netherlands (amongst others) stand out by providing such an exemption.

An alternative employed by many jurisdictions, including Ireland, is to prima facie tax dividend income but to provide credit for any foreign tax paid on the underlying profits out of which that dividend income was paid. Depending on the headline rate of tax in the jurisdiction of both the dividend payer and the recipient, whilst this can involve more complexity, the net result may be that little tax is payable.

Tax on sale of subsidiaries

An important factor to consider when determining where to locate a holding company is whether the holding company will be subject to tax on capital gains arising on the sale of shares in its subsidiaries.

Such gains will obviously not be subject to tax in jurisdictions with no or nominal corporation tax, but the same result can often be achieved in jurisdictions which do prima facie tax such as capital gains through the use of a participation exemption. Although these participation exemptions are now widespread, the variety of conditions which are required to be satisfied in order to benefit from them and, in particular, the differing periods of time which the relevant shares need to be held before they can be sold tax free, can make all the difference. For example, where the holding company is expected to retain the shares in its subsidiaries for the medium to long term, the UK's substantial shareholding exemption (which, unlike the UK's dividend exemption, requires a 12 month period of ownership) may be sufficient, but where a shorter holding period becomes important, the Netherlands participation exemption (which has no minimum holding period) may be more attractive.

Exit taxes

Flexibility is a key attribute when operating in today's global business environment, with companies wanting to maximise their ability to respond to the ever changing political, economic, and fiscal landscape. Being able to migrate the holding company of a group with as few financial implications as possible is therefore an important factor to consider when choosing the jurisdiction of any holding company.

But finding a jurisdiction without an exit tax is no easy task. Across the EU, the harmonising effect of the Anti-Tax Avoidance Directives has meant that EU jurisdictions are required to implement exit tax provisions before the end of 2020. And outside of the EU, many developed tax systems have already implemented exit tax regimes in order to protect their tax bases. However, the differences between these exit tax regimes may prove important when determining where to locate a holding company, particularly if the group wants to retain the flexibility to move in the future.

Economic substance requirements

Perhaps surprisingly, tax haven jurisdictions with no, or low, rates of corporate income tax have never been particularly high up on the list of ideal holding company jurisdictions. This is largely due to a combination of the factors set out above including, in particular, their lack of a strong network of tax treaties.

Recent developments do not seem set to change this. In response to moves by the OECD, EU, and several other jurisdictions acting unilaterally to crack down on the use of offshore tax havens, a number of such havens have implemented economic substance requirements. These new rules require entities which are tax resident in the relevant jurisdiction and which are carrying on certain activities, including headquarters functions, to satisfy substance requirements. Failure to comply with the requirements can result in civil penalties, fines and, in some cases, criminal consequences.

Although these economic substance requirements are unlikely to usher in the last days of tax haven jurisdictions playing an important role in international investment structures, they do add another layer of complexity to their use as jurisdictions in which to place the ultimate holding company of a group. Having said that, for some groups, which do not rely significantly on tax treaties, they may be attractive given their simpler tax regimes.

Conclusion

The location of a holding company is driven by many factors other than tax, but even the tax considerations will vary depending on the group's particular circumstances. It is necessary to go back to the fundamentals in order to settle on the tax recommendation.

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