USING THE U.K. AS A HOLDING COMPANY JURISDICTION: OPPORTUNITIES AND CHALLENGES

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INTRODUCTION: AN IDEAL HOLDING JURISDICTION?

At a time when a quintet of septuagenarian comics attempt to revive former glories with a final run of a live show of *Monty Python* in London, it is worth reflecting on the Holy Grail of the international tax practitioner: to find the perfect international holding company jurisdiction.

In this, the holding company jurisdiction needs certain characteristics:

- The possibility of returning profits to shareholders with minimal tax leakage;
- The ability to receive profits from underlying subsidiaries without taxation at home;
- The ability to dispose of investments in the underlying subsidiaries without triggering a tax charge on any profit or gain;
- A good treaty network to ensure that profits can be repatriated to the holding company from underlying subsidiaries, whilst minimizing local withholding taxes; and
- Low risk from anti-avoidance measures that profits of subsidiaries will otherwise be taxed in the holding company jurisdiction.

The U.K. has emerged over the last decade as an increasingly viable holding company jurisdiction, particularly for investments in countries within the European Union. This emergence has been based on the following aspects of the U.K.'s tax regime:

- The fact that the U.K. does not levy withholding tax on dividends paid by its companies to any jurisdiction;
- The introduction of a dividend exemption in 2009, ensuring that dividends received by a U.K. company from overseas subsidiaries are exempt from tax in the U.K.;
- An extensive network of double tax treaties;

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- The reform of some of the U.K.'s more draconian anti-avoidance rules, including its Controlled Foreign Company ("C.F.C.") rules in 2013; and

- The introduction in 2002 of an exemption from U.K. taxation on the disposal of "substantial shareholdings" in subsidiaries by U.K. companies.

However, some of the U.K.'s rules in this area remain less straightforward than might be desirable and this can create uncertainty, particularly in more complex group structures. This article looks at the requirements of the regime, at some of the issues which can arise when the U.K. is used as a holding company, and lastly, how these issues may be resolved.

"A fundamental advantage which the U.K. holds over many other typical holding company jurisdictions … is that it does not levy withholding tax on dividends paid by U.K. companies."

DIVIDEND TAXATION

A fundamental advantage which the U.K. holds over many other typical holding company jurisdictions (such as the Netherlands and Luxembourg) is that it does not levy withholding tax on dividends paid by U.K. companies. This means that the U.K. is extremely tax efficient for the repatriation of dividends to shareholders, regardless of where those shareholders are based and whether a double tax treaty may also apply to provide relief.

The change in 2009 to introduce an exemption for dividends received by a U.K. company from overseas subsidiaries has further bolstered this position. Whereas the U.K. previously operated a credit method for dividends received from overseas subsidiaries, with credit given for foreign tax borne on the underlying profits out of which the dividend was paid, dividends received by a U.K. company from overseas subsidiaries are now generally exempt from tax.

It is possible to qualify for the exemption in a number of different ways. If the holding company is not a "small" company, the most straightforward basis for exemption is where the holding company controls more than 50% of the voting rights in the subsidiary through its shareholdings. Most subsidiaries will satisfy this requirement.

If the holding company is small (which means broadly that, when aggregated with all companies under common control, it has fewer than fifty employees and either its annual turnover or net asset value from its balance sheet do not exceed €10 million), it will be exempt from tax on dividends received from subsidiaries received in qualifying territories. Qualifying territories include any territory with which the U.K. has a double tax treaty containing a non-discrimination provision.

Where neither of these criteria is met (or, where the company is not small and does not hold a controlling interest in the subsidiaries), there are other ways in which dividends can qualify for exemption. These include where the dividend is paid in respect of non-redeemable ordinary shares, where there is a portfolio holding of less than 10% of the issued share capital and economic rights, or where the dividend does not reflect profits derived from transactions which are designed to avoid or reduce U.K. tax.

Whilst there are some anti-avoidance provisions, these will generally only apply where there has been deliberate structuring to manipulate the rules in order to ensure that the dividend exemption applies. These should not be relevant in most circumstances.

The result of the dividend exemption, coupled with the lack of withholding tax on dividends paid by the U.K. holding company, should ensure there is no tax leakage in the U.K. on the repatriation of dividend profits to the ultimate shareholders. Further, the U.K.'s extensive network of double tax treaties and its access to the benefits of the E.U. Parent-Subsidiary Directive should ensure that dividends can generally be received by the U.K. holding company without local withholding taxes.

ANTI-AVOIDANCE RULES

Controlled Foreign Companies

A further development which took effect on January 1, 2013 and which has enhanced the U.K. as a holding company jurisdiction was a change to the U.K.'s Controlled Foreign Companies ("C.F.C.") Regime. The fundamental change is an attempt to make the rules more targeted to scenarios where profits have actually been diverted from the U.K., rather than a more blanket provision which potentially caused overseas profits with a limited U.K. nexus to be subject to U.K. taxation.

In essence, a C.F.C. is a foreign company that is:

1. Resident outside the U.K.;

2. Controlled by U.K. persons; and

3. Subject to a level of tax which is less than 75% of the U.K. corporate tax on such profits (currently 21%, reducing to 20% as of April 2015).

The C.F.C. rules only bite on U.K. companies which have a minimum 25% participation in the C.F.C. (or are entitled to 25% of the C.F.C.'s profits). Where they apply, such U.K. companies will be taxed as if the profits were made by that company in the U.K.

In the case of a U.K. holding company, the C.F.C. rules are therefore only likely to be of relevance where profits are made in a jurisdiction with tax rates below 15%. Further, due to the broad U.K. exemption on dividends, any dividends received by overseas subsidiaries or any capital gains would not cause the C.F.C.'s profits to be subject to U.K. tax.

There are a number of exemptions from the C.F.C. rules and, in particular, they are unlikely to bite where all the significant functions of the overseas company are carried on outside of the U.K. In the case of a general intermediate holding company within an international group, this will often be the case.

Attribution of Capital Gains

Where a company which is not resident in the U.K., and would be closely controlled if it were, makes a chargeable gain on the disposal of an asset, those gains can be attributed to the U.K. "participators" (broadly speaking, the shareholders) of that company for U.K. tax purposes. This can also apply to gains made by indirect subsidiaries. A company is closely controlled if it is under the ultimate control of five or fewer participators. However, no gain would be attributed to a U.K. shareholder who holds less than 25% of an economic interest in the gain made by the underlying company, although this is likely to be satisfied in most cases where a U.K. holding company is used.

However, where relevant, these rules are often overridden by double tax treaties, so that the gain can only be taxed in the jurisdiction in which the subsidiary is located. There is also a specific exemption for companies which are (or which have an ultimate parent which is) listed on a recognized stock exchange.

There are also other exemptions from these rules which will often apply. For example, if the asset which is disposed of is used for the purposes of a trade carried on outside of the United Kingdom, or if it is used for the purposes of economically significant activities carried on by the subsidiary wholly or mainly outside of the United Kingdom, no charge will be imposed on the U.K. holding company.

"Economically significant activities" means, for these purposes, any commercial activities which make use of appropriately competent staff, premises, and equipment, and which provide added economic value commensurate in each case with the size and nature of those activities. Thus, a subsidiary carrying on a typical business activity should not find that it causes the U.K. holding company to fall foul of these rules. Further, if the arrangements under which the gain arises do not form part of a scheme or arrangement with a main purpose of avoiding a liability to U.K. capital gains tax or corporations tax, no charge will apply.

THE SUBSTANTIAL SHAREHOLDINGS EXEMPTION: A MIXED BLESSING?

The earliest of the listed measures to be brought into force in 2002 to make the U.K. a more attractive holding company jurisdiction was the U.K.'s version of a participation exemption, the Substantial Shareholdings Exemption (“S.S.E.”). Unfortunately, this is also the least user-friendly measure and the vagueness of its scope can still deter some from using the U.K. as a holding company jurisdiction. In most vanilla cases, the rules will work perfectly adequately, however there are still uncertainties due both to the requirements of the regime itself and to a lack of clarity and consistency in some of the drafting.

In order to qualify for the exemption from a charge to tax on a gain made on the sale of shares in a subsidiary, the rules impose a number of different requirements on both the company which is sold and the selling entity. The company which is sold must:

- Have been a trading company or the holding company of a trading group or sub-group throughout the 12 month period ending with the disposal; and
- Be a trading company or the holding company of a trading group immediately after the time of the disposal.

There is some latitude with the second requirement, where that requirement would have been satisfied at some point in the previous two years (in other words, the fact that the purchaser of the subsidiary decides immediately to change its business such that it no longer qualifies will not of itself prevent S.S.E. from applying).

For these purposes, a "trading company" means a company whose activities do not to a substantial extent include any activities other than trading activities. The key concepts here are "trading" and "substantial" and, unhelpfully, neither is defined in the statute.

"Trading" is a concept derived from English case law. Broadly speaking, it requires a company to be carrying on activities which amount to a trade, rather than a holding, of investments. There is no definitive test of the existence of a trade, but various indicia will be taken into account including frequency of transactions, the nature of the assets which are dealt in, the structure of the business, and the intention of the company when acquiring any asset for the purposes of its business. The absence of a bright-line test causes uncertainty. However, for example, a commercial property rental business carried on by the landlord would not amount to a trade for these purposes (whereas a development activity, where the intention is to sell the property following development, would). In areas of genuine uncertainty, HM Revenue and Customs ("H.M.R.C.") may provide a non-statutory clearance on the basis of whether S.S.E. applies, although, as this will typically be prior to a sale, the opportunity to make any alterations to the structure to benefit from the relief may have passed.

The statute also does not include any definition of "substantial." However, H.M.R.C. generally takes the view that "substantial" for these purposes means more than 20%. This 20% test is applied both to the net assets of the business and to the income derived by the business, as well as expenditure and time spent by employees on trading or investment activity. This is not, however, a rigid rule and H.M.R.C. may apply some latitude. For example, they will typically accept that a cash balance does not amount to an investment if it is reasonably expected to be required for the purposes of a trade.

In addition, there are certain requirements in respect to the selling entity. This company must:

- Hold a "substantial shareholding" in the subsidiary concerned for at least a 12 month period prior to disposal;
- Be a trading company or the holding company of a trading group throughout that 12 month period; and
- Be a trading company of the holding company of a trading group immediately after the disposal.

A company holds a substantial shareholding in another company if it holds shares or an interest in shares, by virtue of which it holds:

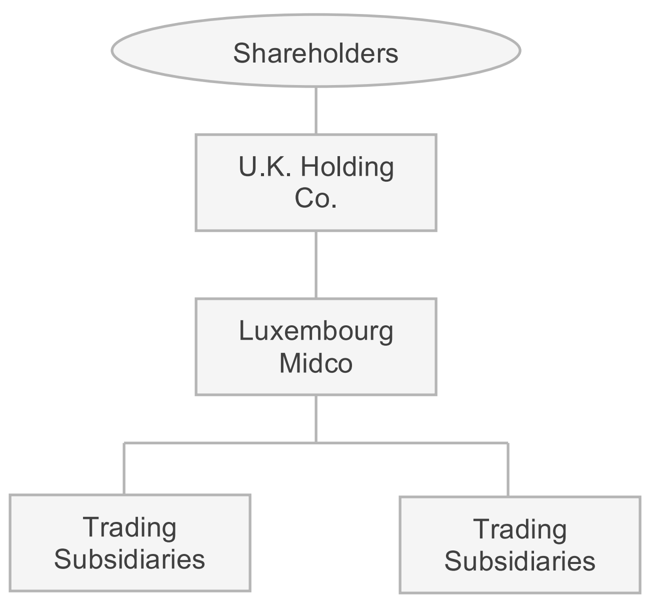
- At least 10% of the company's ordinary share capital;
- A beneficial entitlement to at least 10% of the profits available to equity holders; and
- A beneficial entitlement on a winding up to at least 10% of the assets of the company available for distribution to equity holders.

Care must therefore be taken with share classes which have a variable return if and when certain hurdles are met. Further, "equity holders" in this context includes not just shareholders but the holders of certain types of debt deemed not to be "normal commercial loans," such as convertible debt. Care therefore needs to be taken with smaller holdings in companies with a variety of different share classes and debt instruments.

Remaining a Trading Company

The requirement for the selling company to remain a trading company or the holding company of a trading group after the sale can also cause problems if all the trading entities have been sold. Again, some latitude is provided both by the statute and by H.M.R.C. practice (although the latter is unpublished and by its nature concessionary and may not be relied upon with confidence in a tax planning context). Essentially, if the selling company would no longer form part of a trading group following a sale, H.M.R.C. should accept that S.S.E. will still apply if either it is planned to liquidate the company in the near future to distribute the cash from the sale, or if there is a plan to acquire a new trade or trading group within a reasonable time. However, in any such cases, obtaining a clearance would be advisable.

If instead it is hoped that any cash proceeds from a disposal can be warehoused in the U.K. holding company for the foreseeable future until further opportunities to acquire a trading group or to make an investment present themselves, it is unlikely that S.S.E. would be applicable. In those circumstances, it may be advisable to consider adding a further layer of holding company to the structure in a jurisdiction with a more robust participation exemption, such as Luxembourg. This is shown in the diagram below and adds the additional benefit of utilizing the U.K.'s dividend exemption and lack of withholding tax on dividends to shareholders, whilst relying on the U.K./Luxembourg double tax treaty in respect to dividends paid by Luxembourg Midco to the U.K. holding company.



Joint Venture Companies and Transparent Entities

Further issues can arise when non-corporate entities form part of a group. The general meaning of "group" for the purposes of S.S.E. is a company together with its "51% subsidiaries." A 51% subsidiary is a company in which the other company owns more than 50% of its ordinary share capital. This can create a problem, since an entity without share capital can break the group above and below it. In particular, this can affect a Delaware L.L.C., which may or may not be set up with a share capital (based on H.M.R.C.'s current interpretation).

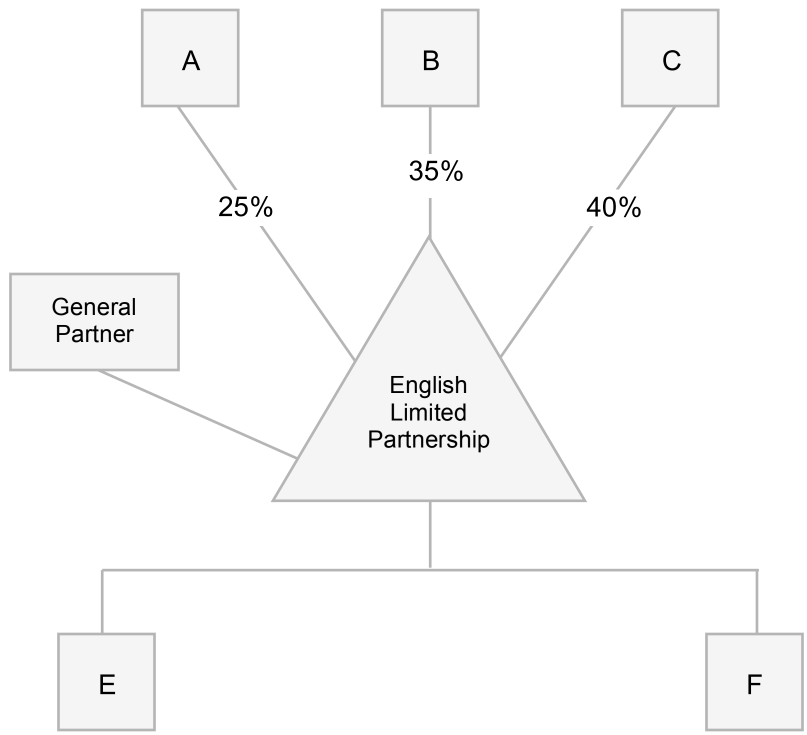
Even entities which are ostensibly transparent for tax purposes, such as a limited partnership, can cause difficulties. H.M.R.C. will generally accept that if such a partnership is inserted within a group and does not have legal personality, then it is entitled to look through it for the purposes of determining whether its subsidiaries should be treated as the 51% subsidiaries of its parent company. This would apply for an English partnership or an English limited partnership, as well as for many other types of limited partnerships which mirror the provisions of English law, such as a Guernsey or Cayman limited partnership.

However, where the partnership which is inserted has legal personality (such as a Scottish limited partnership or a U.K. limited liability partnership which are both treated as transparent for tax purposes), H.M.R.C.'s view is that the group is broken and it is not possible to look through from the parent companies to the underlying subsidiaries. This can cause unexpected problems, and in cases where any group includes companies or entities without share capital, serious care needs to be taken to determine firstly what the "group" is and, secondly, whether it is a trading group.

Similar problems arise in determining whether the rules governing qualifying shareholdings in joint venture companies apply. A company has a qualifying shareholding in a joint venture company if it has a holding of at least 10% (but less than 50%) of the ordinary share capital and there are five or fewer persons who between them hold 75% or more of the ordinary share capital of that company.

In this case, the company is entitled to attribute to itself a proportionate share of the joint venture company (which should be a trading company or the holding company of a trading group). Thus, if A holds a 25% holding in company E, which has four other shareholders, A's holding in E will amount to a qualifying shareholding in a joint venture company. This means that, for the purposes of determining whether A is a trading company or the holding company of a trading group or subgroup, A is entitled to attribute to itself 25% of E's net assets and income.

However, if A actually holds its interest in E through a partnership with other companies, this can create difficulties. Again, the rules are apparently unintentionally inconsistent. For example, if A is not a member of a group, it has a qualifying shareholding in a joint venture company if it holds shares, or *an interest in shares*, by virtue of which it holds 10% or more of that company's ordinary share capital. For these purposes, an interest in shares includes any rights in co-ownership. Thus, if A holds with other companies through a partnership without legal personality, it should qualify as a co-owner of the underlying shares in the joint venture companies E and F below the partnership. This is shown in the following diagram.



However, if the partnership has legal personality, such as a U.K. L.L.P., then arguably A's interest in the underlying subsidiaries will not amount to qualifying holdings in a joint venture. This is because the L.L.P. owns its own assets legally, so that A would have no rights in co-ownership of the shares in E and F.

Further, due to an apparently accidental omission in the drafting, if A is a member of a group, A only has a qualifying shareholding in a joint venture company if it "holds" ordinary share capital in the joint venture company. There is no reference to holding *an interest in shares.* Thus, A would arguably not have a qualifying shareholding in a joint venture company if it holds its interests in E and F through any form of partnership. In such a scenario, taxpayers would be well advised to obtain a view from H.M.R.C.

CONCLUSION

The U.K. has many advantages as a holding company jurisdiction and significant improvements have been made in recent years. However, the substantial shareholding exemption is the most problematic of the U.K. rules in this area. In most basic corporate structures it works well, provided that the trading status of the group is reasonably clear. However, where more complex structures, including fund structures, are involved, the rules are not as user-friendly as they might be.