TAX 101: OUTBOUND ACQUISITIONS – HOLDING COMPANY STRUCTURES

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Tags
International Tax
Foreign Tax Credit
Inversions

When a U.S. company acquires foreign targets, the use of a holding company structure abroad may provide certain global tax benefits. The emphasis is on "global" because standard U.S. benefits such as deferral of income while funds remain offshore may not be available without further planning once a holding company derives dividends and capital gains. This article will discuss issues that should be considered when setting up a company overseas, particularly a foreign holding company, in order to maximize foreign tax credits despite the limitations under the U.S. tax rules, and to reduce the overall U.S. taxes paid. These issues include challenges to the substance of a holding company, recent trends in inversion transactions, the net investment income tax on investment income of U.S. individuals, and the significance of the O.E.C.D. Base Erosion and Profit Shifting report on tax planning structures.

U.S. TAXATION OF INTERCOMPANY DIVIDENDS AMONG FOREIGN SUBS

If we assume the income of each foreign target consists of manufacturing and sales activities that take place in a single foreign country, no U.S. tax will be imposed until the profits of the target are distributed in the form of a dividend or the shares of the target are sold. This is known as "deferral" of tax. Once dividends are distributed, U.S. tax may be due whether the profits are distributed directly to the U.S. parent company or to a holding company located in another foreign jurisdiction. Without advance planning to take advantage of the entity characterization rules known as "check-the-box," the dividends paid by the manufacturing company will be taxable in the U.S. whether paid directly to the parent or paid to a holding company located in a third country.[3] In the latter case, and assuming the holding company is a controlled foreign corporation ("C.F.C.") for U.S. income tax purposes, the dividend income in the hands of the holding company will be viewed to be an item of Foreign Personal Holding Company Income, which generally will be taxed to the U.S.

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[3] Treas. Reg. §301.7701-3(a). If an election is made for a wholly owned subsidiary, the subsidiary is viewed to be a branch of its parent corporation. Intra-company distributions of cash are not characterized as Foreign Personal Holding Company Income, discussed in the text.

parent company, or any other person that is treated as a "U.S. Shareholder" under Subpart F of the Internal Revenue Code.[4]

Nonetheless, the use of a holding company can provide valuable tax saving opportunities when profits of the target company are distributed. The use of a holding company may reduce foreign withholding taxes that may be claimed as foreign tax credits by the U.S. parent. This can result in substantial savings if the operating and tax costs of maintaining the holding company are significantly less than the withholding taxes being saved.

FOREIGN TAX CREDIT – A BLUNT INSTRUMENT

Although the foreign tax credit is often described as a "dollar-for-dollar reduction of U.S. tax" when foreign taxes are paid or deemed to be paid by a U.S. parent company, the reality is quite different. Only taxes that are imposed on items of "foreign source taxable income" may be claimed as a credit.[5] This rule, known as "the foreign tax credit limitation," is intended to prevent foreign income taxes from being claimed as a credit against U.S. tax on U.S. taxable income. The U.S., as do most countries that eliminate double taxation through a credit system, maintains that it has primary tax jurisdiction over domestic taxable income. It also prevents so-called "cross crediting" under which high taxes on operating income may be used to offset U.S. tax on lightly taxed investment income. For many years, the limitation was applied separately with regard to eight different categories of baskets of income designed to prevent the absorption of excess foreign tax credits by low tax foreign source income. In substance, this eviscerated the benefit of the foreign tax credit when looked at on an overall basis. The problem has been eased now because the number of foreign tax credit baskets has been reduced from eight to two, passive and general. On the other hand, the Administration's tax proposals would impair the ability of U.S.–based multinational groups to choose whether to receive dividends from highly taxed or lightly taxed foreign corporations by putting all earnings and all taxes of foreign subsidiaries into common pools so that only a blended rate of foreign tax may be claimed as a foreign tax credit.

The benefit of the foreign tax credit is reduced for dividends received from foreign corporations that, in the hands of the recipient, benefit from reduced rates of tax in the U.S. A portion of foreign dividends received by U.S. individuals that qualify for the 0%, 15% or 20% tax rate under Code §1(h)(11)(B)(i) are removed from the

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4 There are exceptions to the general characterization of a dividend as an item of Foreign Personal Holding Company Income that might apply. One relates to dividends received from a related person which (i) is a corporation created or organized under the laws of the same foreign country as the recipient C.F.C. and (ii) has a substantial part of its assets used in its trade or business located in that foreign country. See Code §954(c)(3)(A)(i). For a temporary period of time, a look-through rule is provided in Code §954(c)(6) under which dividends received by a C.F.C. from a related C.F.C. are treated as active income rather than Foreign Personal Holding Company Income to the extent the earnings of the entity making the payment are attributable to active income. This provision terminated at the beginning of 2012.

5 Code §904(a).

numerator and denominator of the foreign tax credit limitation to reflect the reduced tax rate.[6] This treatment reduces the foreign tax credit limitation when a U.S. resident individual receives both qualifying dividends from a foreign corporation and other items of foreign source income within the same basket that are subject to ordinary tax rates.

As a result, a U.S–.based group must determine the portion of its overall taxable income that is derived from foreign sources, the portion derived in each "foreign tax credit basket," and the portion derived from sources in the U.S. This is not an easy task, and in some respects, the rules do not achieve an equitable result from management's viewpoint.

ALLOCATION AND APPORTIONMENT OF EXPENSES

U.S. income tax regulations require expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.[7] The allocation and apportionment procedures set forth in the regulations are exhaustive and tend to maximize the apportionment of expenses to foreign source income. For example, all interest expense of the U.S. parent corporation and the U.S. members of its affiliated group must be allocated and apportioned under a set of rules that allocates interest expense on an asset–based basis to all income of the group. Direct tracing of interest expense to income derived from a particular asset is permitted in only limited circumstances. Research and development expenses, stewardship expenses, charitable deductions, and state franchise taxes also must be allocated and apportioned. These rules tend to reduce the amount of foreign source taxable income in a particular category and may even eliminate that category altogether. The problem is worsened by carryovers of an overall foreign loss account.[8] This is an "off-book" account that arises when expenses incurred in a particular prior year are allocable and apportionable to foreign source income and those expenses exceed the amount of foreign source gross income of the year. Where that occurs, the loss is carried over to future years and reduces the foreign source taxable income of the subsequent year.

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INVERSIONS AS PART OF GLOBAL MERGERS

The pressure that has been placed on full use of the foreign tax credit by a U.S–based group has resulted in several public companies undergoing inversion transactions. In these transactions, shares of the U.S. parent company that are held by the public are exchanged for comparable shares of a newly formed offshore company to which foreign subsidiaries are eventually transferred. While the share exchange and the transfer of assets may be taxable events, the identity of the shareholder group (*i.e.*, foreign persons or pension plans) or the market value of

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6 See Code §§1(h)(11)(C)(iv) and 904(b)(2)(B).
7 See Treas. Reg. §§1.861-8 through 17.
8 Code §904(f).

the shares (*i.e.*, shares trading at relatively low values) may eliminate actual tax exposure in the U.S. Thereafter, the foreign subsidiaries are owned directly or indirectly by a foreign parent corporation organized in a tax-favored jurisdiction and the foreign tax credit problems disappear.

This form of "self-help" was thought to be no longer available as a result of the inversion rules of Code §7874. In some circumstances, Code §7874 imposes tax on inversion gains and that tax cannot be reduced by credits or net operating loss carry-forwards. In other circumstances, §7874 treats the foreign corporation as if it were a U.S. corporation. However, when global competitors merge, the anti-inversion rules may not be applicable and newspaper accounts have recently focused on companies that have moved from the U.S. in connection with a global merger, acquisition or takeover.

CHOICE OF HOLDING COMPANY LOCATION

In this universe, the combination of foreign taxes imposed on the income earned by a subsidiary and the withholding taxes imposed on the distribution of dividends may generate foreign tax credits in excess of the foreign tax credit limitation. Dividend withholding taxes represent true costs for the offshore parent company because of its location in a tax-favored jurisdiction. Intelligent use of a holding company structure may eliminate or reduce the withholding tax imposed on the distribution of foreign profits. To illustrate, most countries impose a withholding tax on dividends paid to foreign persons. Historically, the rate was often in the range of 25% to 30% when treaty relief was not available and reduced to as little as 5% – in some instances nil – when a subsidiary paid a dividend to its parent corporation resident in a treaty jurisdiction. Other dividends are often subject to withholding tax of 15% under a treaty. Dividend withholding tax is eliminated entirely in the case of dividends paid from a subsidiary resident in the E.U. to a parent company that is also resident in the E.U., assuming that no abuse is viewed to be present in the corporate structure. If the U.S. does not have an income tax treaty in place with a particular foreign country, dividends paid by a subsidiary resident in that country may be reduced or eliminated if the dividend is paid to a holding company located in a favorable jurisdiction. A jurisdiction is favorable if the withholding tax paid on dividends received by the holding company and the withholding tax imposed on dividends paid by the holding company are low or nil and relatively little income tax is paid on the receipt of intercompany dividends or on gains from the disposition of shares of a subsidiary.

NET INVESTMENT INCOME TAX FOR NON-CORPORATE TAXPAYERS

For multinational groups held by fiscally transparent entities in the U.S., such as L.L.C.'s, the maximum rate of U.S. tax for non-corporate members, such as individuals and non-grantor trusts, is 20%. In addition, dividends or inclusions of income under Subpart F or the P.F.I.C. rules are subject to the U.S. "net investment income tax."[9] The tax is imposed at the rate of 3.8% on the net investment income, or if lower, the excess of the individual's modified adjusted gross income[10] over a threshold amount varying from $125,000 to $200,000, depending on the individual's filing status. Net investment income consists of certain passive income reduced by allocable deductions. Passive income includes gross income from dividends. It also includes passive income in the form of interest, annuities, royalties, rents and other gross income if the gross income is derived either from a trade or business in which the U.S. individual does not materially participate or from a trade or business of trading in financial instruments or commodities. Net investment income also includes net gain attributable to the disposition of property held in one of those two types of trade or business activities. Regulations address the application of the 3.8% tax in the case of U.S. individual shareholders in C.F.C.'s or Passive Foreign Investment Companies by providing that the tax may be imposed either at the time of the income inclusion or a subsequent time when cash is received.[11]

INTERCOMPANY DIVIDENDS RECEIVED DEDUCTIONS IN EUROPE

In the European context, many countries have tax laws that provide favorable income tax treatment for intercompany dividends paid across borders. Among these countries are Luxembourg, Denmark, Switzerland, England, Belgium, Spain, Cyprus, and the Netherlands. In Ireland, the tax rate is extremely low for trading profits of Irish corporations. Dividends received by Irish corporations out of earnings of foreign subsidiaries that arise from trading activities may be exempt from tax. The rules in place cause these jurisdictions to be popular locations for the formation of a holding company by a U.S.-based group. Often, however, these countries have other provisions that may be considered less favorable to a holding company. Capital tax imposed on the issuance of shares and stamp tax on the transfer of shares are examples of unfavorable provisions. Other countries that have certain favorable features include Austria, France, and Germany, although none is typically thought of as a holding company location.

CHALLENGES TO EMPTY HOLDING COMPANIES

Tax benefits claimed by holding companies in Europe are now regularly challenged by the tax authorities in the European countries where the paying companies are resident. The challenges are directed at the substance of the holding company. Questions frequently asked include whether the holding company has payroll costs, occupancy costs, and local management that is involved in day-to-day decision making. In some instances, the capital structure of the holding company is queried.

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9 Code §1411.

10 Modified adjusted gross income is the individual's adjusted gross income increased (if applicable) by the excess of the individual's foreign earned income over the deductions, exclusions or credits, including foreign tax credits, allocable to the foreign earned income and not allowed as a deduction in calculating adjusted gross income. Code §1411(d).

11 Treas. Reg. §1.1411-10.

For a U.S.-based group that has little tolerance to tax risk, these challenges suggest that it is prudent for a holding company to have more than tax residence in a particular country – it should conduct group functions in that country and be ready to provide evidence of the activities performed.

These challenges within Europe should be compared with the approach to substance that is found in the limitation on benefits articles of U.S. income tax treaties. Objective standards are often provided under which substance is judged. In addition, active business activities of a group member can be attributed to related parties. In particular, the active trade or business provision of most limitation on benefits articles allows intermediary holding companies to be viewed as active participants in a business if they own at least 50% of a subsidiary or a partnership that has active business operations. These provisions eliminate intra-European challenges of tax authorities and may incentivize direct investment.

O.E.C.D. B.E.P.S. REPORT

Substance is also a key concern in the report on base erosion and profit shifting ("B.E.P.S.") published by the Organization for Economic Cooperation and Development ("the O.E.C.D.").[12] The report was commissioned by the G20. It concludes that data in several studies indicate an increased disparity between (a) the location of actual business activities and investment, and (b) the jurisdiction where the resulting profits are reported for tax purposes.

The report sets out how current cross-border taxation rules may create B.E.P.S. opportunities thereby resulting in a reduction of the share of profits associated with substantive operations. It also emphasizes on how changes in global business practices are ahead of current international tax standards, with a special focus on intangibles and the digital economy. The report identifies (i) a need for increased transparency on the effective tax rates of multinational enterprises and (ii) the existence of key pressure areas as far as B.E.P.S. is concerned. They include (i) international mismatches in entity and instrument characterization, (ii) application of treaty concepts to profits derived from the delivery of digital goods and services, (iii) the tax treatment of related party debt-financing, (iv) captive insurance and other intra-group financial transactions, (v) certain aspects of generally recognized transfer pricing rules, (v) the effectiveness of anti-avoidance measures, and (vi) the availability of harmful preferential regimes.

The report concludes that a set of comprehensive, global, internationally coordinated action plans should be developed and adopted by O.E.C.D. member countries and G-20 non-member countries to effectively address the identified problem areas. The O.E.C.D. governments are particularly committed to the development of proposals to implement this action plan. Many U.S–.based

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12 "Addressing Base Erosion and Profit Shifting," Organization for Economic Cooperation and Development, February 12, 2013.

multinational groups fear that the proposals will overturn arm's length principles that have been recognized internationally for many years.[13]

While the B.E.P.S. report has no legal authority, it indicates how the issue could be addressed in examinations by tax authorities in Europe and in legislation already in the pipeline in several countries. Consequently, the B.E.P.S. report must be considered before setting up a foreign holding company, with particular attention being given to the three tax planning structures identified in the report.[14] To illustrate, in a press release dated June 20, 2014, regarding a meeting of the Council of Economic and Finance Ministers ("E.C.O.F.I.N."), an agreement was announced in the parent-subsidiary directive designed to eliminate the exemption enjoyed by parent companies for dividends paid by subsidiaries when the subsidiary claims a deduction for the payment.

The B.E.P.S. report reflects a view that is now generally accepted by tax authorities on a global basis. Taxation should not be viewed as an expense. Rather, it reflects a partnership profit sharing arrangement between governments and businesses. When schemes with no substance are followed to deprive the governments of their "profit share," businesses may conclude that proper tax planning practices have been followed for the benefit of their investors, while governments may conclude that they are the victims of theft.

The formation of a holding company can be an attractive strategy to a U.S.-based group of companies; however, there are many considerations to consider, including B.E.P.S., the foreign tax credit limitation, as well as the rules on inversion transactions. For each jurisdiction, it is important that the tax treatment of holding companies is carefully examined and planned in order to gain the maximum benefit of the structure.

13 Declaration on Base Erosion and Profit Shifting, Meeting of the OECD Council at Ministerial Level, Paris, May 29-30, 2013.

14 "Addressing Base Erosion and Profit Shifting," Annex C – Examples of MNE's tax planning structures, Organization for Economic Cooperation and Development, February 12, 2013.