Analysis

International holding structures: are they structurally sound?

Speed read

With the backdrop of the continually changing global tax landscape, there are a host of international tax issues and complexities associated with corporate holding structures. International tax legislation is evolving quickly, particularly with regards to three key areas of focus for holding structures, being: (i) corporate residence; (ii) a top down approach to taxation and (iii) access to a double tax treaty network. Recent legislative changes are impacting typical group holding structures with issues compounded by the fact that groups are dealing with these changes during a global pandemic and in light of the UK's departure from the EU single market. With more changes on the horizon, it's important that holding structures are reviewed and if necessary adapted in order to be structurally sound.

Jenni Bullivant
PwC
Jenni Bullivant is a tax director at PwC UK specialising in advising international groups. Having worked with diverse businesses across a range of industries for more than 25 years, Jenni focuses on advising international groups at key stages of their lifecycle from expansion, restructure and refinance up to repatriation and exit. Email: jenni.bullivant@pwc.com; tel: 07841 569 001.

Creina Kane
PwC
Creina Kane is an international tax senior manager at PwC who advises businesses on a range of international tax matters. She specialises on international structurings, including reorganisations, mergers, acquisitions, hive downs and disposals. Email: creina.k.kane@pwc.com; tel: 07706 284 648.

Aaron Mehta
PwC
Aaron Mehta is a manager within the PwC international tax & treasury team. He has experience in advising on a broad range of international tax issues, including on acquisitions and mergers, multi-territory group restructurings, cross-border financing and management of foreign exchange exposure. Email: aaron.mehta@pwc.com; tel: 07483 406 669.

It has been impossible to miss the global shift in recent years calling for greater tax transparency, reform of taxing rights and demands for taxpayers to pay their 'fair share'. The response, which started domestically, has spread to the construction of wider reaching international tax reform. This development has been heightened in light of a global pandemic which has seen governments pour funds into maintaining the structural integrity of economies across the world. Once the dust has settled, large multinationals will likely be asked to play their part in reducing deficits through further reforms of the global tax system.

Reform started when the OECD initiated its BEPS project in 2012. The resultant action plan was designed to provide minimum international standards to counter 'tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax'.

Building on those foundations, the EU issued Anti-Tax Avoidance Directives (ATAD I and II). These contain a series of anti-abuse measures, which are also designed to provide a minimum level of protection for the EU market, while ensuring a fairer and more stable environment for businesses.

Topping out is some way off. More significant changes are being considered, most notably the OECD's two pillar proposals to reform the taxation of the digital economy. Pillar one looks at the attribution of revenues between market jurisdictions, while pillar two deals with the imposition of a minimum tax. 'Success' would likely require a fundamental rewrite of national tax legislation in perhaps more than 100 countries, with effects on all globally engaged groups.

The impact of all these tax changes is compounded by the fact that multinationals are dealing with them in the midst of a global pandemic and, where there are UK/European business arrangements, the consequences of the UK's departure from the EU single market.

In this article, we examine three areas of particular uncertainty in tax for international holding structures: corporate residence; a top down approach to taxation; and access to double tax treaty network.

Residence

International holding structures should be reviewed to ensure they are not adversely affected by any unintended changes in corporate residence due to the impact of the BEPS multilateral instrument (MLI) or travel restrictions under the covid-19 pandemic.

As readers will know, the starting point for determining corporate tax residence is usually the place of incorporation. However, this is frequently overridden by rules that treat a company as resident where either its central strategic management or its effective day to day management is undertaken. Bilateral tax treaties ('treaties') generally determine tax residence first by reference to the relevant countries' domestic tax rules. Hence, if two countries regard a company as resident, this conflict needs to be resolved in order to prevent double taxation.

MLI

The multilateral instrument (MLI) enables the implementation of treaty-related measures developed through the BEPS project in existing treaties in a synchronised and efficient manner.

The residence tie-breaker in UK treaties was mostly based on where the company was 'effectively managed'. However, since the introduction of the MLI, effective management tie-breakers have been removed from some of the UK's treaties in favour of competent authority determinations, which were previously seen only in a handful of treaties, including those with the US and Netherlands.

HMRC noted in its *International Manual* (at INTM120070) that it 'will generally not seek to revisit any previous determination of the treaty residence position so long as all the material facts remain the same'. However, this does not preclude treaty benefits from being subsequently denied under the conditions of the principal purpose test (PPT). In this case, HMRC could seek a new determination from the date on which the modification (to the treaty tie breaker clause) came into effect, subject to agreement between the relevant competent authorities. While seeking to improve dispute resolution between tax authorities, this change to residence tie-breakers could leave taxpayers in a difficult position should the competent authorities fail to reach agreement, with the consequence being that the entity is unable to avail of reliefs or exemptions by virtue of the treaty.

Covid-19

As mentioned above, central strategic management or effective day to day management can signal tax residence. This is commonly evidenced by minutes of board meetings where directors meet in person to agree strategic matters. However, if board members participate at these meetings virtually, or the strategic decision making starts to occur outside of these board meetings, the timing and location of the strategic central management and control, and thereby the residence of the entity, may come into question.

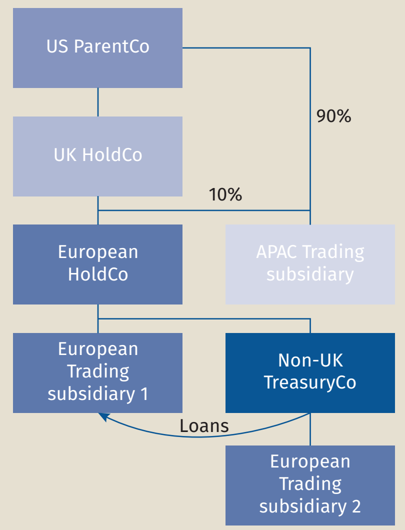
Current restrictions on international travel have created difficulties where, for example, an entity's board of directors consists of non-local resident individuals. The OECD guidance of April 2020 states that the covid-19 pandemic is unlikely to create any changes to an entity's residence under a treaty, saying that the 'usual' location of board meetings, where the CEO or senior executives carry on their activities, or 'ordinary' place of effective management (if the treaty contains the pre-2017 OECD Model tie-breaker rule), should be considered. What about companies that do not have a track record of 'usual' to date?

The OECD refreshed its guidance in January 2021 focusing on the temporary displacement of individuals. For residence generally, it refers to a temporary location change as an extraordinary and temporary situation due to the covid-19 pandemic; but in cases of dual residence, it seems to caveat that this is where it is the result of a public health measure imposed or recommended by at least one of the governments involved. However, a different approach may be appropriate if the change in circumstances continues when covid-19 restrictions are lifted and if virtual board meetings become the norm.

HMRC also released guidance in April 2020 (at INTM120185), explaining that the existing treaty framework is capable of making sufficient allowances for 'extraordinary and temporary' arrangements. The guidance did not change the rules to be applied in the UK, nor offer a safe harbour for this period. Instead, HMRC emphasised that temporary arrangements resulting from the covid-19 crisis are unlikely on their own to change an entity's residence. But one year on, the question arises as to whether arrangements put in place last March can still be considered extraordinary and temporary? Additional comfort can be found in the OECD's most recent guidance, but this represents only the words of the secretariat, not a consensus of member states.

This uncertainty is unnerving as tax residence establishes the framework to be applied for taxation such that clarity is fundamental to taxpayers and in turn their international holding structures. With the backdrop of the global pandemic, the determination of residency can be difficult due to ongoing travel restrictions and enforced quarantine measures. Coupled with this, the varying residency tests, the reduced ability to self-assess the position and the risk of dual-residency (which can equate to double taxation), can mean taxpayers face uncertainty. But support can be provided. Groups could, for example, consider changing the composition of boards, as is the case for European Holdco, with competent directors resident in the local territory. Alternatively, where local statute provides for tax-neutral intra-group transfers, groups may consider

Example holding structure



transferring activities to locally incorporated entities which are de facto tax resident in the territory in question. Both possibilities require appropriate governance structures to ensure residence determination is simplified. Groups could also consider streamlining the number of entities in the holding chain, thereby potentially reducing the complexity of residency entirely.

A top-down approach to taxation

International holding structures should be reviewed to address various instances of a top-down approach being applied to taxation. Notably, these include changes to domestic legislation as a result of ATAD I (including changes to the UK CFC rules) and potential changes that would be needed under the OECD's pillar two proposals.

CFC regimes

The controlled foreign company (CFC) regimes are meant to discourage companies from moving profits from the parent company, typically in a high tax jurisdiction, to subsidiaries in lower tax jurisdictions. The CFC rules broadly operate to permit the jurisdiction where the parent company is resident to tax those profits in certain situations.

The current UK CFC rules came into effect on 1 January 2013, and some European member states had also implemented CFC rules before the entry into force of the ATAD. However, domestic CFC regimes were not harmonised at the EU level and some were held to be incompatible with the fundamental freedoms guaranteed under EU law. Following the adoption of ATAD I, certain CFC regimes, including the UK's, were amended to be fully compliant with EU directives. Two specific changes were required to the UK CFC rules, namely to:

- the definition of control; and
- the exemption for profits generated by UK significant people functions (SPFs).

Under TIOPA 2010 s 371RG, the definition of control now includes the shareholdings of associate enterprises. Looking at our example, the UK HoldCo holds a 10% shareholding of the APAC trading subsidiary, so the UK CFC rules would not seem to apply. However, under the revised definition of control, the shareholdings of US ParentCo, as its associated enterprise, must be considered; as a result, the APAC trading subsidiary is now a UK CFC, which is in line with the intended policy objective of ATAD. However, this change in the definition of control, when combined with the acting together rules in s 259ND and partnership rules in s 259NE, would seem to go beyond the intended scope of ATAD, and this requires UK groups to also evaluate whether any minority partnership interests or joint venture relationships give rise to additional CFCs.

As a result of ATAD I, HMRC revised the group financing exemption in TIOPA 2010 s 371IA. From 1 January 2019, the group financing exemption does not apply to non-trading finance profits derived from assets and risks for which relevant SPFs are carried out in the UK. This was the foundation of the EU Commission's findings that the UK CFC regime unlawfully granted state aid. Consequently, it is now necessary to assess the non-trading financing profits allocable to UK SPFs, as opposed to applying the group financing exemption. HMRC issued guidance ('HMRC statement regarding European Commission decision on state aid SA.44896') in December 2019 which sets out its updated views on determining SPFs in the context of financing activities.

We understand HMRC tends to consider the outcome of an SPF analysis is likely to be binary in a large number of intragroup funding situations such that there are either 0% or 100% UK SPFs. In reaching this decision, it is likely that it will consider and weigh the 11 factors set out in its December 2019 guidance referenced above. Hence, it is necessary for taxpayers to consider each of the factors which HMRC views as relevant in determining an SPF when undertaking any international restructuring.

The Chapter 9 exemption continues to be available to non-trading finance profits arising from capital investment from the UK. This is reassuring as we understand that HMRC is taking a wide view of what constitutes 'relevant UK funds or other assets', which creates uncertainty for taxpayers.

The first area of uncertainty is in respect of TIOPA 2010 s 371EC(4)(a), which states that relevant UK funds or other assets includes 'funds or other assets which represent, or derive (directly or indirectly) from, any capital contribution to the CFC made (directly or indirectly) by a UK connected company'.

The second area of uncertainty is in respect of TIOPA 2010 s 371EC(4)(d), which states that relevant UK funds or other assets include 'funds or other assets which represent, or derive (directly or indirectly) from, any funds or other assets received by the CFC (directly or indirectly) from a UK connected company', subject to an exception in s 371EC(5) for funds or other assets received in exchange for goods or services provided by the CFC, or by way of a loan.

In our view, in order for funds or assets to fall within either of these definitions, it must be possible to trace them back to a UK company. This interpretation is consistent with the purpose of the CFC legislation, namely to counter an artificial transfer of value out of the UK. Further, it is consistent with the s 371EC(5) exemption which allows capital funds to pass out of the UK when either there is no reduction in value (i.e. by way of loan) or funds pass by way of commercial transactions (i.e. in exchange for goods or services).

However, HMRC appears to be taking a wider view of this provision, by treating all CFC's funds and assets as UK capital under the control of the UK, such that a capital contribution of funds from one CFC to another falls within s 371EC(4)(a) and a dividend from one CFC to another falls within s 371EC(4)(d).

Looking back at our example, assume that UK Holdco had acquired European Holdco and its subsidiaries from a non-UK group and, at the point in time of the acquisition, the financing structure was already in place. Our understanding is that HMRC agrees that, in this situation, Non-UK Treasury Co's profits do not fall within s 371EC. However, if Non-UK Treasury Co were to either distribute its loan receivable to European Holdco or contribute it to European Trading Subsidiary 2, HMRC would consider that this causes the profits to fall within the scope of s 371EC.

In light of these differing views, care should be taken when undertaking international restructurings to ensure HMRC's views are appropriately considered for UK holding companies which have CFCs generating non-trading financing profits.

ATAD

While all EU member states were required to introduce ATAD compliant CFC rules, there was no requirement to include provisions preventing multiple taxation resulting from the cascading application of multiple countries' CFC rules to chains of subsidiaries. Although a foreign CFC charge is a creditable tax for UK CFC purposes per TIOPA 2010 s 371PA, it is far from certain that all EU member states will follow this approach as it is not required by ATAD I.

OECD pillar two

The OECD released blueprints on pillars one and two in October 2020. The pillar two blueprint discusses several mechanisms envisioned to establish a global framework of minimum taxation, including the subject to tax rule (STTR) and the income inclusion rule (IIR).

The STTR is the primary taxing rule under pillar two, which enables source countries to protect their tax base by denying treaty benefits for deductible intra-group payments made to low tax jurisdictions.

The IRR is the secondary taxing rule, which operates in a similar way to a CFC rule by taxing a domestic taxpayer on its share of the foreign income of any controlled subsidiary. However, unlike the CFC rules introduced as part of ATAD, the intention is for only the ultimate parent to operate the IIR, albeit it will tier down to the holding company if the ultimate parent does not adopt pillar two.

Access to double taxation treaty network

International holding structures should also be reviewed in light of BEPS measures to counter treaty shopping, recent CJEU cases and, in some EU member states, recent legislation.

Principal purpose test

Access to an extensive treaty network has long been a desirable attribute for taxpayers when determining the location of their operations and holding companies. In 2012, however, treaty 'shopping' was identified as a key area to be addressed by the BEPS project, and this is something that was addressed by the MLI.

Article 7 of the MLI contains a minimum standard which provides for the adoption of a PPT, under which benefits are denied if one of the principal purposes of transactions or arrangements is to obtain treaty benefits (e.g. nil or reduced withholding tax), unless it is established that granting them would be in accordance with the object and purpose of the provisions of the treaty.

The PPT should now be considered when seeking to access benefits provided by treaties entered into by the UK and covered for the purposes of the MLI. The OECD model commentary is the main blueprint for interpretation and the guidance on article 29 of that commentary is useful. It includes (at para 176) an example of treaty shopping via the transfer of an income stream to obtain the benefit of reduced withholding tax under a treaty. However, most scenarios are unlikely to be this clear cut and (at para 182) there are numerous examples to help establish the parameters, including:

- Example F, which considers a group acquiring a target holding company ('Target') which itself holds subsidiaries and is benefiting from the treaty between Target and its subsidiaries. Post-acquisition, if the parent decides to keep Target in place due to that favourable treaty network, that is not a purpose relating to the transaction, namely the acquisition of Target and its subsidiaries, such that the PPT should not apply.
- Example G, which considers a regional management services company where there are multiple commercial reasons behind the choice of location for that company, such as access to a qualified labour force, a flexible legal system or banking service, but also importantly where the company is actively carrying on a commercial business in the provision of services. Where this is the case, the fact that the location chosen also has a favourable treaty with the service recipients would not, in itself, suggest the PPT was failed and benefits denied.
- Example H describes establishing a regional holding company to facilitate the commercial expansion of the business which proved difficult from the parent's home country. It notes the regional holding company was chosen for closer proximity to business partners, access to transportation, access to foreign language speakers, and importantly it undertook clear business activity. All this combined meant that, if the holding company funded the subsidiary and took advantage of favourable treaty rates, it was unlikely absent other factors to result in the PPT being failed.

The examples helpfully establish boundaries and note the value placed on in-territory substance.

Beneficial ownership

But this is not the end of the story: alongside the PPT is the requirement that treaty benefits require the recipient to be the 'beneficial owner' of interest, royalty or dividend income. This requirement existed in most treaties before the MLI, but it was given a renewed focus by EU member states following the CJEU judgments in the Danish beneficial ownership cases – *N Luxembourg 1* (Case C-115/16), *X Denmark* (Case C-118/16), *Danmark I* (Case C-119/16) *and Z Denmark* (Case C-299/16) and *T Danmark and Y Denmark Aps* (C-116/16 and C-117/16) – (the 'Danish cases') that were released in February 2019. In these judgments, the CJEU ruled that member states must deny the benefit of the Interest and Royalty Directive (IRD) and the Parent-Subsidiary Directive (PSD) to abusive holding companies, even if there is no national (or bilateral) provision tackling abuse. The CJEU provided indicators for the assessment of an abusive arrangement which could be regarded as effectively introducing a beneficial ownership requirement in order for the PSD to apply.

The Danish cases not only precipitated legislative change in certain EU member states, but they also heralded an increased focus by national tax authorities over the issue of beneficial ownership. In Belgium, there has been a significant increase in tax audits focused on alleged abuse concerning passive income flows through intermediaries. Amendments have been made to the Dutch Corporate Income Tax Act and the Dividend Withholding Tax Act. In Spain, the tax authorities are increasingly raising questions over beneficial ownership and tax substance.

Therefore, while the OECD commentary remains the correct reference for all territories in interpreting beneficial ownership in treaties, member states now have the additional EU anti-abuse concept to consider when considering beneficial ownership – and there is no uniform approach to that. So, while all should follow the international meaning of the phrase, different territories interpret that international meaning differently.

Although PPT and beneficial ownership are two different tests, the boundaries have been blurred by the introduction of abuse of law test when considering the latter. The OECD and the CJEU both refer to an assessment of the level of substance present in the arrangements. Whilst substance alone is not a panacea to either test when considering incremental group functions, using a jurisdiction in which the group already has operations and adding another layer of functions to that company may go some way to mitigating the risk of a successful challenge under either test.

Brexit

Now that the UK is no longer a member of the EU, any new EU legislation will not apply to the UK. As announced in the recent Budget, the domestic legislation enshrining the IRD in UK law will be repealed with effect from 30 June 2021. Accordingly, WHT rates on interest payments out of the UK will depend on the UK domestic law or the rates set out in the relevant treaty.

The UK's lack of a domestic dividend WHT means that the implications of the absence of the PSD in a UK domestic outbound perspective may be limited, although this limitation is by no means reciprocal. EU member states are no longer required to apply the PSD when considering WHT on dividends or other distributions to UK parent companies. Instead, the rate of WHT will be determined by the relevant treaty between the EU member state and the UK. There are some notable treaties which do not reduce this to nil, including those the UK holds with Germany, Italy, Austria and Portugal.

As tax authorities look to raise revenue to compensate for the expense of emergency covid-19 pandemic measures, access to treaties and, in particular, beneficial ownership and the application of the PPT are expected to be an area of focus. Taxpayers should therefore consider their holding structures in light of these areas and, given Brexit, ensure their holding structures remain resilient with appropriate contemporaneous documentation of the purposes they are serving.

Closing remarks

International holding structures were constructed on the basis of various well-established principles and rules. However, the tax environment is experiencing a fundamental redesign, which is leading to increases in groups' effective tax rates, shifts in tax authorities' approach to taxation and an increasing frequency of wide reaching changes to tax regimes, with a particular increased focus on intra-group transactions. All of the areas addressed above should be considered both for existing international holding structures and for those currently being planned. ■

For related reading visit www.taxjournal.com

- Corporate residence following HMRC's revised guidance (A Anand, 13.9.20)
- Interpreting double tax treaties in light of the BEPS multilateral instrument (J Robson & J Webster, 31.8.17)
- The Danish conduit cases: a landmark ruling on withholding tax and abuse of rights (A Howard, 21.3.19)
- International business operating models (H McKenzie, L Keegan & G Orpwood, 3.12.20)