A REAPPRAISAL OF UK HOLDING COMPANIES FOLLOWING THE FINANCE ACT 1994

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UK holding companies have taken on a new lease of life since the passing of the Finance Act 1994. Previously, the problem of surplus advance corporation tax ("ACT") presented a major obstacle to the use of UK companies as holding companies for international groups. That problem was particularly acute where distributions were made by UK companies out of foreign source profits which had borne foreign tax. The Finance Act 1994[2] introduced a new regime for foreign income dividends ("FIDs") and international headquarters companies ("IHCs"), which largely eliminates the problem of surplus ACT in the context of distributions out of foreign source profits.[3]

This article will consider the background to the new regime, particularly in the context of wider developments within Europe in the field of taxation. It will then examine key features of the new regime and look at a number of tax planning issues. Finally, it will comment on other advantages of UK holding companies, drawing comparisons, where appropriate, with other European holding company jurisdictions.

A. The Background to the New Regime

The introduction of the new regime for FIDs and IHCs is the culmination of a process which has been going on for some time. Since the passing of the

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2 s.138 and Sch 16 Finance Act 1994.

3 The key provisions of the new regime are set out in Part I Sch 16 FA 1994. These provisions have been enacted as ss.246A-246Y of the Income and Corporation Taxes Act 1988 (ICTA 1988).

parent/subsidiary directive in 1990,[4] there has been a growing trend within Europe to introduce international holding company regimes or to make the existing regimes more attractive. The Netherlands is of course well known for its long standing participation exemption regime covering both dividends and capital gains derived from qualifying shareholdings, but in recent years other countries have sought to compete with it.

In 1990, Luxembourg introduced the SOPARFI[5] and extended its participation exemption to cover capital gains as well as dividends. Belgium followed in 1991 by increasing the exemption[6] in respect of dividends from qualifying shareholdings to 95 per cent and also introducing an exemption in respect of capital gains. In France, provisions had already come into effect in 1990 granting qualifying French holding companies exemption from the French equalisation tax or *précompte* (but not from withholding tax) in respect of distributions out of foreign source dividend income. In 1993, France went on to increase its exemption in respect of dividends from qualifying shareholdings from 95 per cent to 100 per cent, although it did not go so far as to introduce an exemption from tax on capital gains from the sale of foreign shareholdings.[7] Finally, with effect from 1994, Germany extended its participation exemption regime in respect of qualifying shareholdings in companies resident in treaty countries to cover capital gains as well as dividends and also granted exemption from German equalisation tax (but not from withholding tax) in respect of distributions by a German holding company out of foreign source income.[8]

The moves to relax equalisation taxes, at any rate in Germany and the UK, were also prompted in part by the report issued by the Ruding Committee in 1992.[9] In its report,[10] the Ruding Committee identified the operation of equalisation taxes in member states having imputation systems as one specific area where there

4 Directive 90/435/EEC.

5 *Société de participation financière.*

6 Strictly speaking, it is a deduction rather than an exemption.

7 However, there is a special regime for long term capital gains under which gains from the sale of non-portfolio shareholdings which have been held for at least two years are only subject to French tax at a reduced rate of 19%.

8 The list is by no means exhaustive. So far as EU member states are concerned, reference should also be made to the participation exemption regimes in Denmark and Austria.

9 The report of the Committee of Independent Experts on Company Taxation chaired by Mr Onno Ruding.

10 Chapter 10, section 3, heading "Corporation Tax Systems".

were fiscal barriers to cross-border investment. It recommended that discrimination in the taxation of dividends distributed from profits earned in other member states be removed by (inter alia) allowing the foreign corporate income tax paid in respect of the profits comprised in the distribution to be credited against the equalisation tax payable in respect of the distribution itself. This recommendation was broadly supported by the EC Commission,[11] which subsequently held discussions with the governments of the member states concerned, including Germany and the UK, to explore ways of modifying their imputation systems to put this recommendation into effect.

The introduction of the FID regime has also in part been in response to pressure from British industry which has in the past had to suffer a substantial surplus ACT cost as a price of foreign investment. In 1993, the Inland Revenue estimated[12] that the total level of surplus ACT was some £5 billion and was increasing at a net rate of almost £1 billion per year.[13] Much of that surplus ACT was long-term or "structural" surplus ACT resulting from distributions out of foreign source income. The UK government may have been happy to receive the extra tax revenues from surplus ACT, but given the importance of foreign investment to the UK economy, it was questionable fiscal policy to penalise those UK companies which were generating valuable foreign source income and to discourage them from generating more.

Outside investors have also played a role. With the completion of the single market in 1993 and the gradual recovery from recession in Western Europe, there has been continuing interest on the part of companies based outside the European Union in establishing a presence within the European Union. It is common for such companies to look to establish a holding company in a suitable European jurisdiction as a "springboard" for Europe. In the past, many companies, particularly companies from the United States and from countries of the Commonwealth, which might in other circumstances have preferred to establish their European holding companies in the UK, have been deterred from doing so by the unfavourable tax regime. Such holding companies have frequently been established instead in countries such as the Netherlands. As a result, the UK and most especially the City of London have missed out on the economic benefits which such holding company operations bring with them.

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11 See Commission Communication to the Council and to Parliament SEC(92)1118, paragraphs 39 and 40. The Commission did suggest some changes to the recommendation of the Ruding Committee.

12 See paragraph 14 of the consultative document referred to in note 14.

13 After allowing for surplus ACT carried back and offset in prior periods.

Against this background, draft proposals concerning FIDs and IHCs were announced by the then Chancellor of the Exchequer in his budget speech in March 1993 and set out in detail in a consultative document issued at that time.[14] Following a process of consultation, the measures were finally passed into law by the Finance Act 1994 and took effect on 1st July 1994. The new measures go a long way towards encouraging the establishment of international holding companies in the UK. They provide a means whereby the problem of surplus ACT can be wholly or largely eliminated in the context of distributions by international holding companies. They also provide a substantial degree of relief for existing UK companies and should lead to a material reduction in the net annual increase in surplus ACT.

B. Key Features of the New Regime

1. An Outline

The new regime comprises two aspects. There is the basic regime for FIDs[15] and there is the special version of that regime which applies in relation to IHCs.[16]

Under the basic FID regime, where a UK resident company designates a dividend as an FID, it is still liable to pay ACT in respect of that dividend. However, if it subsequently "matches" that dividend with foreign source profits on which it has borne foreign tax qualifying for credit in the UK and makes all the relevant elections and claims, then it will generally be able to recover that ACT even in circumstances where that ACT would otherwise constitute "surplus ACT".

Under the special rules which apply to IHCs, where a UK resident company qualifying as an IHC designates a dividend as an FID, it will not be liable to pay any ACT in respect of that dividend at all, provided that it subsequently matches that dividend with foreign source profit which has borne foreign tax qualifying for credit in the UK and makes the relevant elections and claims. The IHC regime is therefore particularly attractive as it avoids the negative cash flow consequences of the UK ACT regime altogether.

The corollary of the favourable ACT treatment of FIDs is that FIDs do not carry any UK tax credits in the hands of the recipient shareholders. Ordinary dividends paid by a UK resident company do carry UK tax credits in the hands of UK

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14 Consultative document entitled "Corporation Tax - Surplus ACT - Proposals for Reform"

15 See principally ss.246A - 246R ICTA 1988.

16 See principally ss.246S - 246W ICTA 1988.

resident shareholders and sometimes also in the hands of non-UK resident shareholders. Furthermore, in some cases, those tax credits entitle the shareholder to a cash refund. In the case of an FID, however, no such credits or refunds are available.

So far as individual shareholders are concerned, dividends received in the form of FIDs are subject to income tax. However, in calculating the tax liability of the individual in respect of the FID, allowance is made for 20% lower rate tax notionally paid, with the result that only a higher rate taxpayer will have additional tax to pay.[17&18]

So far as corporate shareholders are concerned, there is no liability to corporation tax in respect of an FID, and there is not supposed to be any liability to income tax either. However, owing to a drafting error,[19] strictly speaking, a non-UK resident company which is outside the charge to UK corporation tax may still be within the charge to UK income tax at the lower rate of 20% in respect of an FID. The Inland Revenue have indicated that this error will be remedied in due course but that in the meantime they do not intend to seek to charge lower rate income tax against non-resident corporate shareholders receiving FIDs.[20]

The new regime for FIDs and IHCs is relatively complex. It would go beyond the scope of this article to attempt to set out a detailed description of the new

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17 Income tax is charged on the amount of the FID grossed up by the amount of the tax notionally paid. Thus, an FID of £80 is treated as income of £100 which has borne income tax of £20. A higher rate taxpayer will have a further £20 of income tax to pay.

18 In the case of a non-UK resident person, liability to UK income tax on UK source dividend income is proposed to be eliminated as from the 1996/97 tax year by the provisions contained in Clause 128 of the Finance Bill currently before the UK Parliament (except where the dividend is income in relation to which the individual has a "UK representative" within Clause 126 of the Finance Bill).

19 In s.246D(5) ICTA 1988.

20 The Finance Bill currently before the UK Parliament does not contain any provision specifically correcting the original drafting error. However, the provisions contained in Clause 128 of the Finance Bill (see note 18 above) also apply to non-UK resident companies. Once enacted, those provisions will, with effect from the 1996/97 tax year, eliminate any lower rate income tax liability to which a non-UK resident company may be subject in respect of an FID (except where the FID is income in relation to which the company has a "UK representative" within Clause 126 of the Finance Bill).

regime.[21] Instead, it is intended to discuss a number of key areas and to comment on some related tax planning issues.

2. Dividends Qualifying as FIDs [22]

In order for a dividend to qualify as an FID, an election designating it as an FID must be made not later than the time when the dividend is paid or, in the case of a final dividend, when it becomes due and payable.

In addition, dividends may only be designated as FIDs if they are to be paid in cash and if they fall outside the scope of the anti-streaming rules. Very broadly, those rules may apply where there are arrangements for the shareholder to choose whether and in what form dividends are to be paid or where a company seeks to differentiate between dividends paid by it in respect of the same class of shares or different classes of shares.[23]

3. Matching FIDs with Foreign Source Profits[24]

As mentioned earlier, in order to qualify for ACT recovery in respect of an FID, it is necessary (inter alia) to "match" the FID with foreign source profits which have borne foreign tax qualifying for credit in the UK.[25]

The rules concerning the "matching" of FIDs with foreign source profit provide for a considerable degree of flexibility as regards both the nature of the profit, the period to which it relates and the entity in which it arises. This flexibility is important as, once the FID has been paid or becomes due and payable, the election designating it is an FID will become irrevocable. At that point, any right to shareholder tax credits will be irrevocably lost in relation to the FID. This will continue to be the case even if relief from ACT in respect of the FID is subsequently lost because the FID cannot be matched with qualifying foreign source profit.

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21 For a detailed description of the new regime, see 'Foreign Income Dividends and International Headquarters Companies' by D L Hinds, published as Chapter H6 of *Strategic Tax Planning* (Supplement 13, September 1994, Gee Publishing Limited in association with Sweet & Maxwell Limited).

22 See generally ss.246A and 246B ICTA 1988. See also s.834(3) ICTA 1988.

23 But for this purpose, certain fixed-rate preference shares may be disregarded.

24 See generally ss.246J and 246K ICTA 1988.

25 As regards the UK foreign tax credit system, see C.3 below.

As regards the nature of the foreign source profit available for "matching", basically, an FID can be matched in whole or in part against the after-tax amount of any income or chargeable gains in respect of which the company in question is chargeable to UK corporation tax but is entitled to credit for foreign tax. This therefore covers not only dividend income from foreign subsidiaries and associates but also profits from foreign branch operations and miscellaneous taxable foreign profits. This is broader than the corresponding French regime which only covers foreign source dividend income.

As regards the period to which the profit relates, the company is entitled to match the FID against qualifying foreign profit arising either in the accounting period in which the FID is paid or in the immediately preceding accounting period or, failing that, in a subsequent accounting period.[26] As regards the entity in which the profit arises, there is flexibility to match the FID not only against qualifying foreign profit of the company by which it is paid but also against qualifying foreign profit of any "51% subsidiary" of that company. As will be seen below, this last point is particularly important for tax planning purposes.

4. Maximising the Recovery of ACT[27]

The rules as to the level of the ACT recovery are rather complex. They are relevant not only in relation to the basic FID regime under which the ACT has to be paid at the outset and subsequently reclaimed, either in cash or as an offset, but also in relation to the IHC regime where ACT may subsequently fall due if the conditions for it to become recoverable under the basic FID regime are not subsequently satisfied. In summary, the rule is that the company in question is entitled to recover the ACT which it has incurred in relation to FIDs paid by it during a particular accounting period to the extent of the lesser of (basically):

(a) the total amount of its ACT for the period less any part of that ACT which has been relieved or which would have been relieved but for the use of other ACT carried forward or surrendered, and

(b) the notional amount of its surplus ACT for the period, calculated on certain assumptions and, most particularly, on the assumption that its matched foreign source profits were its only profits for the period and that its qualifying FIDs were its only distributions for the period.

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26 But foreign source profits arising in an accounting period which commenced before 1st July 1993 are not available for matching: s.246Y(b) ICTA 1988.

27 See generally ss.246N and 246P ICTA 1988.

The operation of the rules concerning the level of ACT recovery give rise to a number of tax planning points. In particular, it is important to try to ensure that the actual unrelieved ACT does not work out to be less than the notional foreign source ACT, otherwise part of the ACT relief available under the FID/IHC regime will effectively be lost.

In view of this principle, it will generally be preferable to locate any UK taxable profits in a subsidiary of the company paying the FID rather than in the paying company itself. If the UK taxable profits were to be located in the company paying the FID, then the whole or part of the ACT paid in respect of the FID would be automatically offset against the company's mainstream corporation tax ("MCT") liability in respect of its UK taxable profits. This in turn would reduce the extent to which the ACT paid in respect of the FID could be recovered. By locating the UK taxable profits in a subsidiary of the company paying the FID, such automatic offset is avoided and the ACT recovery under the FID regime is maximised. At the same time, the parent company may well have deductible losses (e.g., excess interest charges or management expenses) or ACT in respect of ordinary dividends which it can use to offset the MCT liability of the subsidiary.[28]

Similarly, if the company paying the FID has foreign source profits which have borne foreign tax at less than the applicable UK corporation tax rate, it may be appropriate to locate those profits in a subsidiary of the company paying the FID. Here again, this avoids the ACT paid in respect of the FID being automatically offset against MCT liability arising in the paying company. The MCT liability will arise in the subsidiary and may instead be offset by ACT paid by the parent company in respect of ordinary dividends.

A particular variation of this type of situation arises where a foreign "mixer" company is used in order to average out foreign tax rates for the purposes of UK foreign tax credits[29] and the average foreign tax rate is less than the applicable UK corporation tax rate. In such circumstances, it may now be preferable to use two such mixer companies. One of those companies could be used to average the foreign tax rates down to the applicable UK corporation tax rate. As dividends received from that company would not be liable to any UK corporation tax at all, they could be efficiently used to fund FIDs. The profits arising in the other mixer company would then be subject to a correspondingly lower average foreign tax rate and the whole of the residual UK corporation tax liability would fall on the dividends received from that company. That residual MCT liability might then

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28 By means of group relief under s.402 ICTA 1988 on a surrender of surplus ACT under s.240 ICTA 1988.

29 For more detailed comment on UK foreign tax credits, see C.3 below.

be offset by the surrender of ACT paid by the UK parent company on ordinary dividends.

5. The Three Categories of IHC[30]

The special version of the FID regime which applies in relation to IHCs is attractive not only because it offers complete exemption from ACT but also because of the broad definition of the term "IHC", which focuses entirely on the characteristics of the shareholders of the company in question and the levels of their shareholdings.[31]

Basically, a company qualifies as an IHC in relation to an accounting period if, throughout the accounting period, it falls within any one of the following three categories:

(a) it is a wholly-owned subsidiary of a foreign quoted company;

(b) it is a wholly-owned subsidiary of a "foreign held company"; or

(c) it is a company at least 80% held by foreign individuals or "foreign held companies".

(A) Wholly-Owned Subsidiary of Foreign Quoted Company

A company falls within this category if it is a wholly-owned subsidiary of a non-UK resident company the shares in which were quoted on a "recognised stock exchange" outside the UK throughout the accounting period in question and the preceding twelve months and were the subject of dealings on that stock exchange at some time during that period. The foreign quoted company may not be listed on a "recognised stock exchange" in the UK during that period, unless that listing is only a secondary listing. This category also extends to second tier sub-subsidiaries which are effectively wholly-owned by the foreign quoted company.

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30 See generally s.246S ICTA 1988.

31 Despite the use of the term "international headquarters company", there is no requirement for an IHC to operate as the headquarters of an international group or to carry on any particular group management or co-ordination activities or to employ any UK personnel for that purpose. Nor are there any particular requirements as regards the level of the foreign or UK assets which the IHC is required or allowed to hold or the level of the foreign or UK profits which it is required or allowed to earn. In this regard, the UK regime may be contrasted with the corresponding regime in France.

(B) Wholly-Owned Subsidiary of "Foreign held Company"

In order to fall within this category, a company must satisfy two requirements:

(i) it must be a wholly-owned subsidiary of a "foreign held company", that is to say, a company at least 80% of the share capital of which is owned by non-UK resident persons (or which is a wholly-owned subsidiary of a company which is so owned); and

(ii) not more than 20% of its ordinary share capital may be ultimately (beneficially) owned by UK resident persons (other than companies).

(C) Company 80% held by Foreign Individuals or Foreign held Companies

In order to fall within this category, a company must satisfy three requirements:

(i) not less than 80% of its share capital must be owned by non-UK resident persons (other than companies) and/or by foreign held companies (as defined above);

(ii) each of its shareholders must own at least 5% of the share capital; and

(iii) not more than 20% of the company's ordinary share capital may be ultimately (beneficially) owned by UK resident persons (other than companies).

There is a particular rule that, except for the purposes of the 20% restriction on ultimate UK beneficial ownership, the ownership of a particular percentage of the share capital of the company is to be determined by reference to the beneficial ownership of share capital carrying that percentage of rights to vote at a general meeting of the company. In view of this, it may be possible to issue non-voting preference shares to a third party (including a UK resident third party) without adversely affecting the company's status as an IHC or its ability to avoid the impact of the anti-streaming rules in relation to FIDs which it pays in respect of its ordinary shares.

So far as the 20% restriction on ultimate UK beneficial ownership is concerned, there is provision for the ultimate beneficial ownership of shares to be determined by tracing through corporate shareholders to the ultimate non-corporate shareholders "on such basis as is reasonable". Clearly, there may be difficulty in some cases in establishing ultimate beneficial ownership and it remains to be seen how reasonably the UK Revenue will act in practice in requiring companies to prove that the 20% restriction is satisfied.

6. The use of IHCs

As mentioned earlier, where a company which qualifies as an IHC pays an FID, it is not liable to pay any ACT in respect of that FID. However, in order for the company to preserve its exemption from ACT in respect of that FID, it is necessary that it should continue to qualify as an IHC until the end of the accounting period in question and that it should make all the same elections in respect of that FID as it would have to make if it were not an IHC. If it turns out that the company was not an IHC for the period or that some of the ACT in question would not have qualified for relief under the normal FID regime, then the company will after all be required to pay the whole or part of the ACT in question.

There are two main situations where the use of a UK IHC is likely to be attractive for tax planning purposes. First, a company resident outside the EU might wish to hold the shareholdings in its EU subsidiaries through a UK IHC. Dividends flowing from the EU subsidiaries to the IHC will normally be exempt from withholding tax under the EU parent/subsidiary directive, subject, however, to the derogations granted in favour of Germany and Portugal[32] and the anti-abuse provisions which have been introduced in France, Italy, Spain and most recently, Germany.[33] The UK corporation tax liability on the dividends received will normally be fully covered by foreign tax credits and exemption from ACT will be available under the IHC regime if the onward dividends to the non-EU parent are paid as FIDs. If exemption from UK tax on capital gains is required as well, it may be appropriate to interpose a holding company situated in, say, the Netherlands underneath the UK IHC. This is considered further at D.4 below.

Secondly, it may be attractive for a company resident in one foreign country to hold the shares in a subsidiary resident in another foreign country through a UK IHC in order to take advantage of the dividend withholding tax relief or exemption available under the double taxation agreement between the UK and the country of residence of the subsidiary. This will apply particularly in a case where comparable treaty relief or exemption would not be available in respect of a dividend paid directly from the subsidiary to the parent. One specific context where this may be relevant is in relation to US subsidiaries of Netherlands holding companies caught by the "limitation of benefits" provision in Article 26 of the new

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32 See Articles 5.3 and 5.4 of directive 90/435/EEC.

33 Pursuant to Article 1.2 of directive 90/435/EEC.

US/Netherlands double taxation agreement. Such US subsidiaries might perhaps instead be held through a UK IHC established as a wholly-owned subsidiary of the Netherlands parent, although it is understood that the US Treasury is resistant to the idea of the restrictions in the US/Netherlands treaty being circumvented in this way.[34]

C. Other Advantages of UK Holding Companies

Even once the surplus ACT problem has been eliminated, the question still remains, why use a UK holding company? There is no single answer to this question. What type of holding company is suitable in any particular case will rather depend on the circumstances of the case. There are, however, various specific advantages of using a UK holding company.

1. No Withholding Tax on Outgoing Dividends

The fact that the UK does not charge any withholding tax on outgoing dividends will be a significant advantage is some cases. This will be particularly important where the shareholder is resident in a tax haven and consequently does not enjoy treaty relief from dividend withholding taxes. However, even where the shareholder is resident in a normal taxing jurisdiction and that jurisdiction has a double taxation agreement with the relevant holding company jurisdiction, treaty relief will still not normally serve to eliminate dividend withholding taxes altogether.[35] Where the withholding tax exemptions under the parent/subsidiary directive are combined with the ACT exemption under the UK regime for IHCs, then as mentioned in B.6 above, the use of a UK holding company offers an attractive means for a non-EU parent to minimise withholding taxes on profits arising from its EU operations.[36] Where the non-EU parent is situated in a tax haven, the routing of dividend flows through a UK holding company will be more efficient in tax terms than conventional structures such as using a Netherlands/

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34 In particular, the possible application of the provisions contained in Article 16 of the UK/US double tax treaty needs to be considered, although it is doubtful whether those provisions could be applied in such a case.

35 For example, only some nine Netherlands double taxation agreements grant exemption from dividend withholding tax and none of the Belgian or Luxembourg double taxation agreements reduce dividend withholding tax below 5%.

36 The possible application of the anti-abuse provisions in France, Italy, Spain and Germany should, however, be borne in mind where subsidiaries in those countries are involved.

Netherlands Antilles structure and will be surer than more recent innovations such as the use of holding companies based in Madeira.

2. Extensive Double Tax Treaty Network

So far as incoming dividends are concerned, the benefits of the withholding tax exemptions afforded by the parent/subsidiary directive (as implemented into national law in the various EU member states) are of course not exclusive to UK holding companies. However, when it comes to treaty relief, the UK has the advantage of having the largest network of double taxation agreements of any country in the world. As at 1st November 1994, it had comprehensive agreements in force with 92 countries and under negotiation or signed but not yet in force, with a further 12 countries.[37] Most or all of these agreements provide relief from withholding tax on incoming dividends and many of them also provide relief from foreign capital gains tax on the sale of foreign shareholdings.

The UK double tax treaty network is particularly strong in relation to Commonwealth countries. Furthermore, in many Commonwealth countries there may be intangible advantages in using a UK company to hold the local branch or subsidiary rather than using a company established in a civil law jurisdiction. This arises out of long standing commercial and cultural ties and local familiarity with the English language and the English legal system.

3. Foreign Tax Credit System

The fact that the UK operates a credit system rather than an exemption system in respect of income from foreign branches and subsidiaries may on the face of it appear to be a draw-back when compared with some other European holding company jurisdictions which operate exemption systems. However, the lack of an outright exemption will not generally result in additional tax liability.[38] That is because UK corporate tax rates are equal to or lower than the corporate tax rates in most other developed countries and, at the same time, the UK system of foreign tax credits is a generous one, at least as regards the availability of credit for

37 It also had limited agreements (covering international transport) in force with 14 countries and, under negotiation or signed but not yet in force, with a further 6 countries. It also had 10 estate duty conventions in force and one signed but not yet in force.

38 Although it may involve greater compliance costs.

underlying foreign tax.[39] A UK resident corporate shareholder is entitled to credit not only for foreign withholding tax on dividends received but also for foreign corporate tax borne in respect of the relevant underlying profits by a related company resident outside the UK in which it holds at least 10% of the voting power.[40] Furthermore, there is no limit on the number of tiers of related companies in respect of which credit for underlying tax may be claimed provided that each company in the chain controls at least 10% of the voting power of the next company.[41]

Even where some of the foreign subsidiaries bear foreign taxes at rates less than the applicable UK corporate tax rate, liability to UK tax on the dividends distributed up to the UK parent can still generally be avoided provided that there are other foreign companies in the group which are liable to tax at a higher rate. UK tax law does not itself provide for foreign tax credits to be pooled but rather provides for them to be calculated on a source by source basis. However, it is common and accepted practice for such a pooling effect to be achieved by channelling all the foreign profits through a "mixer" company located in a suitable intermediate holding company jurisdiction in order to arrive at an average foreign tax rate for foreign tax credit purposes not less than the applicable UK corporate rate.

4. Deductions for Interest Charges and Management Expenses[42]

The corollary of the fact that the UK operates a credit system rather than an exemption system in respect of foreign source income is that interest charges and management expenses paid by the UK company will generally be deductible against its total profits for UK tax purposes, provided that the UK holding

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39 It is however not so generous as regards the source by source basis of computation discussed below, the lack of relief for foreign tax in excess of the corresponding UK tax and the lack of any right to carry forward unused foreign tax credits.

40 s.801 ICTA 1988. Cf the minimum shareholding requirements for dividend exemption in other holding company jurisdictions, e.g., the Netherlands and Belgium (5%), Luxembourg, France and Germany (10%), Denmark and Austria (25%).

41 Cf the position in other EU member states which operate credit systems, which is understood to be basically as follows: Spain - credit for first tier subsidiaries only; Portugal - credit for 50% of underlying tax for first and second tier subsidiaries only; and Ireland - statutory credit for first tier subsidiaries, no statutory credit for lower tier subsidiaries but allowed by concession in certain circumstances.

42 See generally ss.75 and 338 ICTA 1988.

company qualifies an "investment company" for UK tax purposes. This is basically a company whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived from those investments.[43] Such an investment company will be able to deduct all payments of interest qualifying as "annual interest", that is to say, broadly speaking, interest on debts capable of lasting and intended to last for more than one year. Under domestic UK tax law, non-annual or "short" interest is only deductible by an investment company if is payable in the UK on an advance from a UK bank, stockbroker or discount house.[44] However, this restriction may well constitute unlawful discrimination contrary to the provisions of Article 59 of the EC Treaty (freedom to provide services).[45]

Where deductible interest charges or management expenses do arise, it will generally be preferable to locate them in a different UK company from the one which receives the foreign source dividend income. It is usual to adopt a two-tier structure for this purposes. Under that structure, the funds would be borrowed and the interest charges incurred at the level of the main UK holding company, whilst the shares in the foreign subsidiaries or associates would be held and the foreign dividend income received at a level of a wholly-owned UK subsidiary of the main UK holding company (commonly referred to as a "DV income trap" company). This ensures that the foreign tax credits can be utilised in full against the UK tax liability on the foreign source dividend income and in priority to the interest deductions being so used. The interest losses arising in the UK holding company can then be offset against any taxable profits which it has or surrendered to other companies in the group[46] by way of group relief or carried forward to later years.

In this respect, the regime in the UK is much more generous then that in the Netherlands, where interest charges incurred in respect of a loan used to finance the acquisition of a foreign shareholding would not be deductible at all. It is also more generous than the regime in Luxembourg, where such interest charges may only be deducted against taxable income to the extent that they exceed the amount of the exempt dividend income from the foreign shareholding. The position is,

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43 s.130 ICTA 1988.

44 s.338(3)(b) ICTA 1988.

45 A similar restriction affecting the ability of foreign investors to deduct interest incurred on loans from foreign lenders to finance investments in UK real property (s.353(1)(b) ICTA 1988) was lifted by s.81 Finance Act 1994 in response to pressure from German banks. It is quite possible that the corresponding restriction in respect of charges on income may be similarly lifted in due course, failing which it could well be challenged through the courts.

46 Provided that they are 75% subsidiaries for the purposes of s.413 ICTA 1988.

however, comparable to that which arises in Belgium, though with one important difference. As a Belgian holding company would remain liable to Belgian tax in respect of 5% of its foreign source dividend income, it would in any event need to use an initial tranche of its management expenses and interest charges to cover that element of taxable income. In the UK, assuming that the UK tax liability in respect of the foreign source dividend income was fully covered by foreign tax credits, no such offset would be required.

5. Thin Capitalisation Rules

Where any of the interest charges in respect of which deductions are claimed include interest on related party debt, attention must be paid to the UK rules dealing with thin capitalisation. In a Press Release[47] issued following the budget statement on 29th November 1994, the Inland Revenue announced a proposal to put the UK thin capitalisation regime onto a more satisfactory statutory basis. With effect from that date, the rule whereby interest paid on a loan from a 75% parent or fellow subsidiary resident outside the UK is deemed to constitute a distribution for UK tax purposes[48] will only apply to the extent that that interest exceeds the amount which would have been paid between unrelated parties.[49] That limitation will no longer be dependent on the lender being resident in a country which has a double taxation agreement with the UK containing a specific overriding provision.[50]

It seems, however, that the determination of what is or is not excessive will continue to be governed by non-statutory practice. The current practice of the UK Revenue is to adopt a conservative starting point requiring a debt:equity ratio of 1:1 and an interest cover of three times. However, more favourable ratios can frequently be negotiated. A debt:equity ratio of 2:1 or 2.5:1 is by no means unusual and even debt:equity ratios of twice this level can sometimes be sustained.

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47 IR46, to which are attached draft amendments to s.209(2) ICTA 1988. These are now incorporated in clause 87 of the Finance Bill currently before the UK Parliament.

48 At present contained in s.209(2)(e)(iv) ICTA 1988.

49 Strictly speaking, the new rule will also apply in relation to interest paid to a 75% parent or fellow subsidiary resident in the UK, but only where that company is not within the charge to UK corporation tax in respect of that interest.

50 Up to now, this has been problematical. Whilst the agreements with most of the UK's more important trading partners do contain the requisite overriding, many other UK agreements do not. Notable omissions within Europe include Greece, Ireland and Portugal.

This is better than the 1.5:1 "safe harbour" ratio which applies in France.[51] It is not, however, as liberal as the new thin capitalisation regime in Germany, which applies a "safe harbour" ratio of 9:1 to holding companies and 3:1 to other companies.[52]

6. Favourable Treatment of Liquidation Distributions

Another important point to note in relation to UK holding companies is that, under UK tax law, liquidation distributions are not treated as distributions at all, but rather as the consideration received by the shareholder for the disposal of the shares on the liquidation.[53] Consequently, such distributions will not give rise to liability to ACT. This arises whether or not the company has distributable foreign profits out of which it could pay FIDs.

A similar position arises in Belgium and Luxembourg, where liquidation distributions can be paid without withholding taxes. In a number of other holding company jurisdictions, however, liquidation distributions are treated as distributions for tax purposes and are therefore subject to local withholding taxes.

The use of a liquidation distribution will therefore in some cases be an attractive way of stripping all of the remaining assets out of a UK company without incurring any further liability to UK tax. This does, however, assume that the assets of the company are all sterling cash assets or other assets in respect of which no chargeable gains will be realised on a liquidation of the company.

7. Other Fiscal Advantages

Other fiscal advantages of the UK as a location for an international holding company include:

(a) the fact that the UK has a relatively low corporate tax rate. Even the 33% standard rate of UK corporation tax is fairly low by

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51 Although it should be noted that the thin capitalisation regime in France can easily be circumvented altogether.

52 In many cases, the effective position in Germany may be even more generous by virtue of the fact that the debt:equity ratio is not calculated on a global basis but, rather, separately in relation to each lending shareholder. Debt:equity ratios even higher than 9:1 are permitted in Belgium.

53 s.209(1) ICTA 1988 and s.122 Taxation of Chargeable Gains Act 1992.

European standards.[54] However, in some cases,[55] the rate of UK corporation tax will be only 25% or a rate between 25% and 33%, depending on the level of the profits of the UK company and the number of other companies with which it is associated;

(b) the fact that a UK holding company enjoys various advantages in relation to taxation by virtue of UK membership of the EU. As well as the benefit of the parent/subsidiary directive which has been considered earlier,[56] it is entitled (inter alia) to freedom from discriminatory tax treatment in other member states[57] the benefit of the directive dealing with the tax treatment of cross border mergers;[58]

(c) the fact that, unlike the Netherlands, Luxembourg and Belgium, the UK does not charge any capital duty on the issue of shares.[59] Also, unlike Germany and Luxembourg, it does not charge any net worth tax or municipal trade tax;

(d) the favourable tax regime for expatriate employees working in the UK; most particularly, the fact that an individual who is "domiciled" (in the English law sense) outside the UK is only liable to UK tax on foreign source investment income and capital gains and on income from a wholly foreign employment to the extent that such income is (actually or constructively) received in or remitted to the UK;[60]

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54 Only the three new member states, Austria, Finland and Sweden, have standard corporate tax rates lower than 33%.

55 Where small companies' relief applies under s.13 ICTA 1988.

56 See B.6 and C.1 above.

57 See especially Arts 52, 58 and 59 of the EC Treaty. See also (inter alia) the decisions of the European Court of Justice in Case C330/91 *R v IRC ex parte Commerzbank AG* [1993] STC 605 and Case C1/93 *Halliburton Services BV v Staatssecretaris van Financiën* [1994] ECR I-1137.

58 Directive 90/434/EEC.

59 Note that those countries also have minimum share capital requirements.

60 There are also favourable rules relating to the tax treatment of individuals who are resident but not "ordinarily resident " in the UK.

(e) the new tax regimes for foreign exchange gains and losses and interest rate and currency contracts,[61] which will help greatly in rationalising the tax treatment of treasury operations carried out in the UK.

8. Non-Fiscal Advantages

There are also a number of non-fiscal advantages of UK holding companies. These include:

(a) the fact that a UK holding company enjoys the benefits of UK membership of the EU, including direct access to the single market and the rights of freedom of establishment in other member states and freedom to provide services in other member states;[62]

(b) the fact that London is a major world financial centre;

(c) the lack of special restrictions on foreign investment in the UK;

(d) in relation to investors from other English speaking countries, the fact that the UK shares a common language with those countries and frequently already has strong cultural and commercial ties with those countries.

D. Disadvantages of UK Holding Companies

There are several potential disadvantages of UK holding companies which should be borne in mind, although in many cases these can be satisfactorily dealt with in practice

1. Potential Tax Liability on Dividends Received

As the UK operates a credit system rather than an exemption system for the taxation of foreign source dividends, if the effective foreign tax liability on the dividends received by a UK holding company from a particular source (including the tax on the underlying profits out of which those dividends have been paid) is

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61 These regimes are contained principally in ss.125-170 Finance Act 1993 and ss.147-177 Finance Act 1994 and are due to come into effect in relation to accounting periods commencing on or after 23rd March 1995.

62 See especially Arts 52, 58 and 59 of the EC Treaty.

lower than the UK tax liability on those dividends, the UK tax liability it will only be partly covered by the foreign tax credits and the balance of it will remain due. However, as mentioned earlier, such tax liability may be mitigated if the UK holding company also has dividends from another foreign source which have borne foreign tax at a higher rate and the foreign tax is averaged out by using a foreign "mixer" company.[63]

2. Potential Tax Liability under CFC Regime[64]

If the UK holding company owns and controls a non-resident subsidiary which is subject to tax in its country of residence on its profits (excluding net capital gains) for any accounting period at less than three-quarters of the corresponding UK tax rate, then that subsidiary will constitute a "controlled foreign company" ("CFC") and its profits for that accounting period (excluding net capital gains) will be liable to be attributed back to the UK holding company under the UK CFC regime, if the UK Revenue so directs.

However, no such direction may be made in the following cases:

(a) if the CFC pursued an "acceptable distribution policy " in respect of the period;[65]

(b) if the CFC was engaged in "exempt activities" through out the period;[66]

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63 As regards the UK foreign tax credit system and the use of foreign "mixer" companies, see C.3 above.

64 See ss.747-756 and Scheds 24-26 ICTA 1988.

65 Basically the requirement is that, within 18 months after the end of the period, a dividend should have been paid by the CFC to its UK resident parent which, in the case of a trading CFC, is not less than 50% of the accounting profits (excluding net capital gains) and, in the case of a non-trading CFC, is not less than 90% of the profits as adjusted for UK tax purposes (but excluding net capital gains and creditable foreign tax). See paragraphs 1-4 Sched 25 ICTA 1988.

66 The categories of exempt activity include the cases where the CFC has a business establishment in its country of residence and is effectively managed there and either (a) its main business does not consist of either investment business or dealing in goods for delivery to or from the UK or to or from connected persons or (b) it is a holding company and at least 90% of its gross income is derived from companies which it controls and which fall within (a) above. See paragraphs 5-12 Sched 25 ICTA 1988.

(c) if the CFC satisfied the "public quotation condition" in respect of the period;[67]

(d) if the profits of the CFC for the period (as adjusted for UK tax purposes) did not exceed £20,000;

(e) if the motive test under the CFC regime is satisfied.[68]

3. Potential Tax Liability on Capital Gains

Unlike the participation exemption regimes which apply in such countries as the Netherlands, Luxembourg, Belgium and now also Germany, the UK regime for IHCs does not provide any specific exemption from UK tax on capital gains arising from the disposal of foreign shareholdings. The problem of UK taxation of capital gains should not, however, be overstated. Where the foreign parent is making a long term investment, the taxation of capital gains may be a less important, or at any rate a less immediate issue. Furthermore, under normal UK tax rules, the purely inflationary part of any capital gain on shares will in any event be exempt from UK tax. In addition, there are various ways in which the UK tax liability on any capital gain arising on the sale of a foreign shareholding may in practice be mitigated:

(a) the UK tax liability might be avoided altogether by holding the shareholding through an intermediate holding company located in a country which has a full participation exemption regime (e.g., the Netherlands) covering capital gains as well as dividend income (provided that the capital gain is not distributed on to the UK parent);

(b) as a refinement of the suggestion in (a) above, the intermediate holding company might perhaps have two classes of shares, one carrying the right to distributions of income and the other carrying the right to distributions of capital gains. The former class might be held by the UK parent and the latter might be held through some suitable alternative structure;

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67 Basically, the requirement is that at least 35% of the voting shares should be beneficially held by the public and should be quoted and dealt with on a recognised Stock Exchange outside the UK. See paragraphs 13-15 Sched 25 ICTA 1988.

68 Basically, the requirement is that the achieving of a reduction in UK tax should not be a main purpose of the transaction or a main reason for the existence of the CFC. See s.748(3) ICTA 1988.

(c) even if the foreign shareholding continues to be held directly by the UK parent, the amount of the capital gain might be reduced by stripping all tax-paid foreign profits out of the foreign subsidiary prior to the sale and then selling the shares for a reduced price;

(d) even if there is an element of chargeable gain after allowing for inflation, if the UK holding company has unrelieved interest charges or management expenses, these may normally be offset against the chargeable gain for UK tax purposes.

If the UK holding company is successful in minimising the UK tax liability on the capital gain arising on the sale of a foreign shareholding but then wishes to distribute that capital gain on to its foreign parent by way of dividend, the payment of that dividend may give rise to surplus ACT.[69] There are, however, various ways in which such surplus ACT may be avoided or mitigated:

(a) if the IHC has sufficient tax-paid foreign profits, it may instead be able to pay an FID out of those profits and to use the capital gain for other purposes, e.g., to fund new investments;

(b) even if the capital gain is distributed by way of dividend, if the parent company is resident in a country whose double taxation agreement with the UK provides for a partial refund of the tax credit attaching to UK source dividends,[70] the effective rate of UK tax on the distributed gain will at least be reduced;[71]

(c) in addition, the parent company may be entitled to claim credit in its country of residence for the UK tax paid in respect of the distributed gain;

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69 Because there may be insufficient mainstream corporation tax against which to offset the ACT.

70 UK treaties which provide for a partial ACT refund in the case of a substantial corporate shareholder include those with Belgium, Denmark, Finland, Italy, Luxembourg, Netherlands, Norway, Sweden, Switzerland, Canada and the US.

71 Following the reduction in the ACT rate to 25% of the net dividend, where the treaty allows a partial ACT refund to a substantial corporate shareholder it will typically be 6.875% of the dividend or 4.6% of the profit out of which the dividend is paid. The effective UK tax rate is therefore reduced from 33% to 28.4%.

(d) if the gain is distributed to the foreign parent on the liquidation of the IHC, then, as mentioned earlier, no liability to ACT will arise in relation to such a distribution.[72]

4. Potential Upstream Attribution of Capital Gains

If the UK holding company is a "close company" for UK tax purposes,[73] any non-UK resident subsidiary of that company will normally fall within the scope of the UK provisions relating to the attribution of the capital gains of a closely controlled non-UK resident company to its UK resident shareholders.[74] Under those provisions, any capital gains realised by the foreign subsidiary is liable to be attributed back up to the UK parent company, unless certain exclusions apply.

However, if the foreign subsidiary is resident in a country with which the UK has a double tax treaty containing the usual capital gains article, that article will normally have the effect of preventing the UK from charging the capital gain to UK tax. Alternatively, if the foreign subsidiary is not resident in a suitable treaty country, consideration should be given to owning it through an interposed holding company located in a suitable jurisdiction such as the Netherlands and distributing the capital gain up to that company within two years after the time when it arises.[75]

5. Potential Need for Consent of UK Treasury

There is a restriction under UK tax law[76] whereby it is unlawful for a UK resident company to cause or permit shares or debentures in a non-UK resident company over which it has control to be issued or transferred without first

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72 See C.6 above. A liquidation may, however, be inappropriate so long as the IHC still holds shares or other non-cash assets, as these may give rise to chargeable gains on the liquidation.

73 Basically, a company which is under the control of five or fewer "participators" (including associates) or "participators" who are directors. See s.414 ICTA 1988.

74 See s.13 Taxation of Chargeable Gains Act 1992 (TCGA 1992).

75 In order to take advantage of the exclusion in s.13(5)(a) TCGA 1992.

76 See s.765 ICTA 1988.

obtaining the consent of the UK Treasury.[77] Certain types of transaction are automatically covered by certain general consents issued by the UK Treasury.[78] Also, any transaction which constitutes a "movement of capital"[79] between member states is excluded from the usual restriction and is instead only subject to a notification requirement.[80] In other cases, prior consent is required.

A UK holding company which has foreign subsidiaries may find it rather inconvenient to have to apply for and obtain such Treasury consent to transactions proposed to be carried out by its foreign subsidiaries. However, where consent is required, it is most inadvisable to proceed without it, as strictly speaking any person who is knowingly a party to such a breach is guilty of a criminal offence.[81] This may include not only the company in question but also its directors and advisers. It is hoped that this outdated restriction will be repealed or at any rate relaxed in due course, but for the time being it remains in force.

E. Conclusions

The introduction of the new regime for FIDs and IHCs under the Finance Act 1994 has largely removed the main obstacle to the use of UK companies as holding companies for international groups. Admittedly, the regime is rather complex and requires careful administration, but it does provide a solution to the problem of surplus ACT resulting from distributions out of foreign source income.

Having dealt with the surplus ACT problem, the particular advantages of using a UK holding company are able to come to the fore. Key points include the absence of any withholding tax on dividends paid out of the UK, the benefit of a very extensive network of double taxation agreements and of the parent/subsidiary directive and the availability of deductions for interest charges and management

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77 Strictly speaking, in the case of the transfer of shares or debentures, the restriction only applies where the UK resident company owns or has an interest in those shares or debentures. It is therefore arguable that the restriction does not normally apply to a transfer of shares in a foreign sub-subsidiary which are owned by a foreign subsidiary. It is, however, understood that the UK Revenue take the opposite view.

78 See the Treasury General Consents 1988.

79 i.e., a movement of capital to which Article 1 of Council Directive 88/361/EEC of 24th June 1988 applies.

80 See s.765A ICTA 1988.

81 See s.766 ICTA 1988. Note that no prosecution has ever been brought under this section.

expenses. Thus, a non-EU parent may be able to repatriate the profits of its EU subsidiaries without withholding taxes whilst interest costs incurred in financing the acquisition of those subsidiaries may be offset against UK taxable profits.

The lack of an express exemption from UK tax in respect of capital gains derived from the disposal of foreign shareholdings may still prove to be an obstacle to the use of a UK holding company in some cases, particularly where the investment is relatively short term or speculative. However, where complete exemption from tax on capital gains is not a pre-requisite, it may be sufficient that purely inflationary capital gains are exempt from UK tax and that there are various ways of mitigating UK tax on capital gains in excess of inflation. In particular, the possibility of inserting a Netherlands holding company underneath the UK holding company should be considered.

There are also a number of other potential disadvantages of UK holding companies which may be relevant in some cases, particularly where the foreign subsidiary is subject to the CFC regime or the capital gains attributed regime[82] and no double tax treaty relief is available. However, here again, the potential difficulties may generally be be mitigated by using an interposed Netherlands holding company.

To conclude, whilst the provisions of the Finance Act 1994 have not removed all of the potential tax exposures, the UK does now at least merit serious consideration as a jurisdiction for an international holding company. The use of a UK holding company may be not be the best option in all cases, but there are certainly some cases in which it will now be an attractive option.

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[82] See D.2 and D.4 above.