UK FOR AN INTERNATIONAL HOLDING COMPANY (IHC)

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There have been various articles discussing the issues associated with the key tax factors that are to be considered by a group of companies in deciding which jurisdiction is to be used for its holding company. The purpose of this article is to examine the UK position in the international tax context, which hopefully will explain why multinationals have been moving the location for their holding company to the UK.

1 Substantial Shareholdings Exemption ("SSE")

The disposal by UK companies of shares in trading companies from 1 April 2002 may qualify for exemption from UK tax on the gain if they meet the substantial shareholding requirements. Essentially, these are:

- The investing company must have had at least 10% (the substantial holding) of the ordinary share capital in the company invested in throughout a 12-month period beginning no more than two years before the day on which the disposal takes place. The shareholder must also be beneficially entitled to at least 10% of profits available for distribution and 10% of the assets on a winding-up.

- The investing company must have been a trading company or a member of a trading group both throughout the qualifying period and immediately after the time of disposal. It is worth noting that the legislation also exempts certain gains, which would otherwise be chargeable – for example, when the investing company is in liquidation – provided that certain conditions are met.

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- The company invested in must, over the same time period, have been a trading company, the holding company of a trading group or sub-group.

A trading group means a group one or more of whose members carry on trading activity and the activity of whose members taken together do not include "to a substantial extent" activities other than trading activities.

"Trading company" and "trading sub-group" are defined in a similar manner and HM Revenue and Customs have indicated that they will interpret this as meaning 80% of the value of the group must be by reference to trade.

For this purpose, a 51% holding in a company is sufficient to constitute it a group member.

For minority participation special treatment is given in the case of holdings in joint venture companies for SSE purposes.

A joint venture company is defined as a trading company or the holding company of a trading group or sub-group, which has five or fewer persons who, between them, hold 75% or more of its ordinary share capital. A qualifying shareholding in a joint venture company for SSE is 10% or more of its ordinary share capital.

Disposal of the shareholdings that do not meet these requirements will be liable to corporation tax on any gains realised on the disposal. If, however, the computation results in a loss rather than a gain, the loss is allowable if a corresponding gain would have been chargeable, subject to any specific exemptions or restrictions – the converse is also true.

1.1 Trading Companies and Groups

There is no requirement for the company invested in or the investing company to be UK resident. Likewise, the trade need not be carried on in the UK.

Similarly, where group structures are relevant for either the investing company or the company invested in, the group is not limited to the UK resident members. In the context of multinational groups, this is particularly important where a UK holding company is used, which itself is not a trading company but may be a member of a qualifying group by virtue of foreign members of the group.

Although this is not stated explicitly, the references to a group or subsidiary are to be construed with any necessary modifications where applied to a company incorporated under the law of a country or territory outside the UK.

The precise application of this may be uncertain where the foreign corporate law is unclear, or where it is unclear as to whether the entity should be treated as a company for UK tax purposes.

An example is Delaware limited liability companies (LLC). Under Delaware law such entities can issue shares and an LLC agreement may provide that a member's interest in an LLC may be evidenced by a certificate of LLC interest issued by the LLC.

The Revenue view is that if the LLC issues "shares" in this way (or under the section 18-702c of Delaware Limited Liability Act), then they will accept that this to be regarded as ordinary share capital. It is therefore possible for such an LLC to be a member of the group or qualifying joint venture.

1.2 Disposal of Incorporated Foreign Branches

The UK permits the gain on the transfer of the foreign branch of a UK company to a non-resident company in exchange for the shares and loan stock of that foreign company to be deferred.

On the later sale of the foreign company the proceeds of sale may be increased by the amount of the deferred gain. Provided the non-resident company qualifies as a company invested in for the purposes of the SSE, then a disposal of those shares would normally be exempt from corporation tax.

The deferred gain, however, falls outside the exemption, i.e. the legislation requires recovery of the charge postponed on the transfer of assets to the non-resident company.

As for foreign currency risks, any gain or loss, which would have arisen under the foreign exchange matching rules, connected with a disposal of a substantial shareholding, will no longer be a chargeable gain or capital loss.

1.3 Limitation on the Substantial Shareholding Exemption

The anti-avoidance provisions apply to the arrangements from which the sole or main benefit that could be expected to arise is that the gain on the disposal would by virtue of the exemption not be a chargeable gain. For example it may apply if, pursuant to these arrangements, an untaxed gain accrues to company A on the disposal in another company B.

In addition, one of two circumstances must arise. Before the accrual of that gain, company A must acquire control of company B or the same person(s) must acquire control of both companies. Alternatively, before the accrual of the gain, there must be a significant change in the trading activities of company B at a time when it was controlled by company A, or when both were controlled by the same persons.

A gain is untaxed if it wholly or substantially represent profits which have not been brought into account for the purposes of tax on profits for a period ending on or before the date of disposal. Tax for these purposes refers to tax either in the UK or elsewhere.

Arrangements seem to include any scheme, agreement or understanding, whether or not legally enforceable.

2 Taxation of the Dividend Income

Dividends received from a foreign subsidiary by a UK company are subject to UK corporation tax.

A UK company that receives a dividend from an overseas company in which it owns more than 10% of the voting rights may claim a credit for tax paid on the profits of the overseas company and its subsidiaries. This tax is known as underlying tax.

In addition to the underlying tax the UK company may also claim a credit for the withholding tax (WHT) on the dividend received.

Claims have been made that the system of taxing dividends from non-UK residents is contrary to the EC Treaty because dividends from UK companies are exempt from further tax, whereas they are taxable (subject to the application of foreign tax credit) in the case of dividends from non-UK companies.

The taxation of foreign dividends may seem to put UK in a less favourable position for the IHC when compared with other jurisdictions that were historically used for the same purpose. However, the detailed analysis of the UK rules on "the taxation of foreign dividends" could prove to be an administrative cost rather then tax cost to most of the multinationals.

3 Transfer Pricing/Thin Capitalisation

OECD member countries are firmly of the view that the arm's length principle should govern the evaluation of transfer prices among members of multinationals or connected companies for tax purposes.

The UK is a member of the OECD and supports the use of the arm's length principle.

Transfer pricing applies in any situation where there is a provision between two connected persons, i.e. one person controls the other, or both are controlled by a third party.

The controlled person (or persons) must be a body corporate or a partnership; the controlling party however could be an individual. The term 'control' is defined (broadly 51% ownership) and covers, for example, structures where a trust is inserted between an individual and a company.

The legislation can also apply to a provision between a person and a branch of a connected company.

The control rules also include provisions which deem a 40% participant in a joint venture to control that joint venture. A joint venture, for these purposes, is a company or partnership which is controlled by two persons, each of whom has at least a 40% interest in the venture.

With effect for profits arising on or after 1st April 2004, the transfer pricing régime is extended to apply also to transactions within the UK (i.e. between UK entities).

Additionally the separate rules for thin capitalisation are abolished and included in the transfer pricing regime.

The new transfer pricing regime:

- Ends transfer pricing and thin capitalisation requirements for small and medium sized enterprises, except in relation to transactions with a related business in a territory with which the UK does not have a double tax treaty containing a suitable non-discrimination article and except where the Revenue requires (in exceptional circumstances) a medium-sized company to apply the rules;

- Extends the scope of transfer pricing requirements for other businesses, which used to apply only to cross-border transactions, so that they apply to transactions within the UK as well;

- Allows the connected UK businesses to make a corresponding adjustment in the calculation of its taxable income; and

- Exempts companies that are dormant at 1st April 2004 from transfer pricing requirements for as long as they remain dormant.

The Treasury has the power to make regulations adding to the list of territories that qualify even if the double taxation treaty in question does not contain an appropriate non-discrimination article, or to exclude territories even if the treaty in question does contain such an article.

3.1 The definition of small and medium enterprises

The term small and medium sized enterprise is defined using the European Commission recommendation (2003/361/EC) published on 6 May 2003.

The definition applies to any entity engaged in an economic activity, irrespective of its legal form and includes entities subject to income tax as well as corporation tax.

An entity qualifies as either small or medium if it meets the staff headcount ceiling (50 or 250) and one (or both) of the following financial limits:

- annual turnover Euro 10 million/ Euro 50 million,

- balance sheet total Euro10 million/ Euro 43 million accordingly.

Staff includes employees, persons seconded to work for a business, owner managers and partners. Where staff do not work full time during the year they should be counted as an appropriate fraction.

The measures of turnover and balance sheet total are net of VAT and otherwise have their ordinary meaning for accounting purposes.

The Commission recommendation recognises that in two situations the staff and financial data of connected and associated enterprises must be included with that of the enterprise seeking exemption. It refers to these as linked enterprises and partnership enterprises.

A linked enterprise is an enterprise which has the right to control the affairs of the enterprise seeking exemption. This control can be either direct or indirect and take many forms including shareholding, voting rights and contractual rights.

For the purposes of calculating the data for an enterprise, all data for any second enterprise that is linked to an enterprise must be aggregated as well as all the data for any linked enterprises or partnership enterprises of that second enterprise. All the staff, turnover and balance sheet entries must be taken into account regardless of the extent to which control is effected.

Enterprises will be counted as partnership enterprises where one of them holds 25% or more of the capital or voting rights of the other but they are not linked enterprises. However where linked enterprises jointly hold rights these must be aggregated to see if the 25% threshold has been passed.

The Commission recommendation does not separately define capital or voting rights. These, however, should be interpreted widely.

The definition of SME is now becoming very important for various tax rules and as for the transfer pricing and thin capitalisation, it seems HM Revenue and Customs does mean to end the transfer pricing and thin capitalisation requirements for small (certainly for small) and medium sized enterprises, subject to the requirements mentioned above.

3.2 Election to remain subject to transfer pricing rules

There may be occasions when a business wishes to apply transfer pricing rules even though it would qualify for exemption. A business can elect that the exemption will not apply. An election can be made for a specified chargeable period and will cover all transactions or provisions made in that period. It will be irrevocable.

In cases where transactions as recorded in their accounts are not at arm's length, businesses shall make computational adjustments in their returns.

A business wishing to make an election to remain subject to transfer pricing rules should do so as part of its computation of taxable income in its return.

4 Controlled Foreign Company (CFC)

A company is a CFC if it is resident outside the United Kingdom, controlled by persons resident in the UK and subject to a lower level (less than three quarters of the corresponding UK tax on those profits) of taxation in its territory of residence.

Control means the power of a person to secure the affairs of a company in accordance to his wish. The 40% test as stated above for transfer pricing purposes also applies to a CFC.

A company is exempt from CFC if:

- throughout the period it is engaged in "exempt activities"; or
- it pursues an "acceptable distribution policy" (i.e. 90% of the profits are distributed) or
- it meets the "public quotation" condition, or;
- its chargeable profits for the period do not exceed £50,000, or
- the company is resident in certain excluded territories; or
- the company is able to satisfy the test generally known as "motive test" (i.e. a reduction in UK tax was minimal or that reduction was not the main purpose).

When chargeable profits of a CFC for an accounting period have been apportioned to a company resident in the UK, an amount equal to corporation tax at the "appropriate rate" is assessed on the UK company, less any creditable tax for that accounting period apportioned to the UK company. There is one exception to this rule - if the amount of the profits apportioned to the UK company is less than 25 per cent of the total chargeable profits of the CFC, then no assessment under these provisions can be made on that company.

The assessment is not technically a corporation tax assessment, but the corporation tax rules governing assessment, collection, appeals, interest on unpaid tax and penalties applied. In addition, certain corporation tax reliefs can be claimed against the tax charged.

It is therefore possible for some multinationals to keep their CFC costs to minimum (or eliminate them completely) when the CFC and in fact the transfer pricing legislations are operated in conjunction with other tax rules governing double tax relief, Schedule D Case III , trading losses etc or they are subject to the exemptions mentioned above.

5 Other Relevant Points

As for other taxes and reliefs for IHC, the UK:

- Allows tax deductions for interest payments, either on loans for the trading purposes or for the acquisition of the shares in the subsidiary, for example. However the implications of withholding tax and relevant double tax relief should be considered when the interest is paid to a non EU member (interest and royalty as mentioned below are now paid gross to EU members, subject to certain conditions).

- Allows tax deduction for royalty payments for which the implication of the withholding tax and double tax relief should also be considered when paid to a non EU member.

- Abolished advance corporation tax, which in the international tax context is known as withholding tax imposed on distributions made by a UK company to its overseas holding company (albeit it initially applied to the UK holding company too). In fact the current legislation on distributions made by a UK company to its corporate shareholders does not put any restrictions on the holdings (i.e. number of the shares held), trading status or jurisdictions where the shareholders are resident. This makes the UK a far better environment for IHC when compared with other favourable jurisdictions where the implications of the reduced or nil withholding tax on the distributions would depend upon various factors.

- Imposes no charges on issue of the shares, but 0.5% stamp duty on transfers of shares in certain cases.

- Operates no other charges (e.g. registration charge) or withholding tax on liquidation of a UK company (i.e. in general the UK treats a capital distribution in respect of shares in the course of liquidation as a disposal of those shares).

- Corporation tax rate varies between 0%–30%, which is welcomed by true commercially driven multinationals when the rate is kept within that very range.

- Provides reliefs for trading and other losses, research and development tax credit and/or tax depreciation of certain intellectual property.

6 Conclusion

Obviously when providing groups of companies operating in more than one jurisdiction with tax advice, it is very dangerous to consider the tax implications of a particular jurisdiction in isolation. One should therefore consider carefully the interactions of the laws and other regulations – company, employment, accountancy and tax – both in the domestic and international context, to be able to identify and if possible to eliminate any potential risks (costs) to the groups.

For example, the SSE legislation mentioned above, which is probably the most liberal tax relief being introduced by the UK government when reviewed both in domestic and international context, may however provide no benefit to the group in certain cases. If the subsidiary is resident in another jurisdiction and the gain realised by the UK company on the sale of the shares in that subsidiary is exempt from the UK corporation tax, but such gain is being taxed in the subsidiary's jurisdiction according to its domestic law, then SSE fails to eliminate the group' tax costs.

The other example is the operation of the EC Parent and Subsidiary directive according to which a company resident in one Member State should not impose withholding taxes on the dividends paid to a company resident in another Member State provided certain other conditions of EC parent and subsidiary directive are met.

Where, exceptionally, foreign tax is withheld on a dividend received by a United Kingdom company [on or after 1 January 1992] from a company resident in another Member State in which the United Kingdom company holds the required percentage of capital, no relief apparently should be allowed for that tax, whether by way of credit relief or by way of deduction.

When examining the legislations similar to those mentioned in this article in conjunction with the EC Directives in Spain, Italy, The Netherlands, Sweden, Denmark etc and interaction with the USA, Russian, Canadian, Australian, South African tax and other legislations, one should view the presence of CFC, transfer pricing and taxation of foreign dividend legislations as the tolls used in the UK to shield multinationals from the risks/costs that could appear in the absence of those legislations for IHC purposes , rather than "collecting tax" for which there are many other rules being operated by the HM Revenue and Customs.