The Offshore Taxation Review

THE EUROPEAN HOLDING COMPANY, REVISITED

Milton Grundy[1]

Almost all of what I wrote in my earlier article[2] remains true today: the essence of the holding company regime in continental Europe is that incoming dividends are not taxed but outgoing ones are - usually at the rate of 25% (Sweden 30%), but exceptionally the Hungarian "offshore" company, which enjoys the benefit of the 52 treaties to which Hungary is party, pays tax on outgoing dividends at the rate of only 3.25%. Practitioners in this area have devoted much energy and imagination to reducing or eliminating the tax on outgoing dividends - by using the Antilles for Dutch dividends, by paying interest (in Denmark, Luxembourg and the Netherlands)[3] or by selling to a "dividend-stripping" purchaser, but most significantly by utilising the reliefs afforded by the EU Directive and by tax treaties - and it is in this area that there have been some changes.

In November 1992 the Gibraltarians were still hoping that their 1992 company would come within the scope of the Directive. This has proved to be a chimera. The Madeira SGPS, by contrast, is enjoying a large measure of success. This company is in principle fully liable to Portuguese tax, but is temporarily exempt from tax on non-EU dividends and enjoys a special low rate of tax, amounting to 1.8%, on dividends derived from companies in other European Union countries. Dividends paid by an SGPS are free of tax, except where the shareholder is a

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2 OTPR, Volume 3, 1992/93, Issue 3, at page 171. An updated version of the material contained in that article, and a somewhat fuller treatment of the material in this, may be found in the author's *Offshore Business Centres* (Sweet & Maxwell, 1997).

3 Luxembourg and Netherlands tolerate debt/equity ratios up to 85:15. Denmark has no rule against thin capitalisation.

resident of Portugal or where they arise from non-exempt activities. This is a bold manoeuvre, enabling the non-EU investor to take advantage - indirectly - of the EU Parent-Subsidiary Directive. Countries in the European Union have recognised the right of the SGPS to receive dividends from 25% owned subsidiaries free from withholding tax, though anti-abuse legislation may impose additional requirements - e.g. in France, where a company taking advantage of the Directive must be under the ultimate control of EU residents. Exceptionally, it appears that the Dutch authorities are not at this stage prepared to recognise this right; this may not be altogether surprising, given the Dutch interest in holding companies of their own, but the Portuguese government has questioned the Dutch attitude through diplomatic channels and is understood to be prepared to take legal and political action if need be.

Whatever the position of the SGPS under the Directive, there seems little doubt that it is a "resident of Portugal" for treaty purposes.[4] However, the US-Portugal tax treaty has a limitation of benefits clause regarding the eligibility of companies incorporated in Madeira; and the new treaty with Spain applies to Madeira companies only if their activities are of a genuine industrial or commercial nature or if they are under the control of Portuguese residents. Under certain tax treaties - e.g. Italy - an investor in a Madeira company may be able to claim a tax credit by virtue of a tax-sparing clause. Disagreements with Denmark about various treaty matters - including the eligibility of Madeira companies to take advantage of the Portugal/Denmark treaty - led to the Danes terminating the treaty, but the Directive still applies. It is also useful to remember that a Madeira company is not a non-resident from the point of view of Portugal, so that the Portuguese CFC legislation does not apply to it.

Holding company business is good business, and it is not surprising that several European countries are setting out to attract a share of it. In June of this year, proposals for federal tax concessions for Swiss companies were published, and these are now under discussion. These included the proposed introduction of a flat rate of corporate income tax, the abolition of capital tax and a reduction in stamp duty.

A much more radical approach was initiated by Malta in 1994. Their new tax regime provides, among other things, for the use by a non-resident investor of a

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4 Portugal has treaties with Austria, Belgium, Brazil, Bulgaria, Finland, France, Germany, Ireland, Italy, Mozambique, Norway, Spain, Switzerland, United Kingdom and United States of America. Treaties have been signed with Belgium, Czech Republic, Hungary and Poland; they have been initialled with Greece, South Korea and Venezuela; they are being negotiated with Algeria, Canada, Denmark, India, Luxembourg, Malta, Netherlands, Norway, Pakistan, Rumania, South Africa, Sweden and Tunisia.

Maltese company as a vehicle for foreign direct investment on what is essentially a zero tax basis. Although the holding company is fully liable to Maltese tax on its income, dividends are not taxed in the hands of a non-resident shareholder, and the non-resident shareholder is entitled to a repayment of the tax paid by the Company when distributing, with the result that, so long as the profits are promptly distributed - the net tax cost will be zero. When one bears in mind that Malta currently has 22 tax treaties,[5] it is evident that treaty shopping in Malta can have very spectacular results. Perhaps a little too spectacular: the ingenious offshore regime adopted by Malta could have prompted the United States to rescind its treaty in December 1996. There are fears that other countries may follow suit but a number of new and potential treaty partners appear to accept the regime.[6]

There has also been activity in the European Union. In order to stimulate the development of the economy in less prosperous areas, the European Commission seems prepared to give its blessing to the establishment of low-tax regimes. The pioneer in this area was the International Financial Services Centre in Dublin. This is now being followed by the Centro di Servizi Finanziari ed di Assicurativi in Trieste. The Italian law is in place, but the Centre will not be effective until the Italian Treasury, together with other ministries, promulgates the necessary administrative regulations. When this is done, Trieste will present an extremely favourable location for a holding company, paying no Italian direct taxes but entitled to the benefit of the numerous treaties to which Italy is party.

A similar facility is to be available in the Canary Islands. There the tax rate will be 1% (on non-Spanish income), and no withholding tax will be levied on outgoing dividends or other payments to non-residents. A Canary Islands company is nevertheless a "resident of Spain" for treaty purposes and is entitled to the benefit of the parent/subsidiary directive. This regime is understood to have the blessing of the European Commission, but its formal approval has yet to be given.

Perhaps the most interesting jurisdictions to have come to the fore since my 1992 article are Spain and the United Kingdom.

A new regime for the Spanish holding company - the Entidad de Tenencia de Valores Extranjeros (the "ETVE") was created in December of last year by Law

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5 Malta has treaties with Australia, Austria, Belgium, Bulgaria, Canada, China, Cyprus, Finland, France, Germany, Hungary, India, Italy, Libya, Luxembourg, Netherlands, Norway, Pakistan, Poland, Rumania, Sweden and United Kingdom.

6 Treaties with Czech Republic, Korea and Malaysia have been signed and await ratification. Treaties with Albania, Croatia, Egypt, Kuwait, Thailand, Tunisia and South Africa have been negotiated and await signature.

10/1996. In many respects, the ETVE is quite similar to holding companies found in other parts of Europe, with an exemption from tax on incoming dividends arising from a "participation" in a company which is carrying on business in another country and paying a similar tax there. The ETVE has also a number of features found elsewhere (but not all in the same country) - some relief from tax on capital gains realised on the disposal of the participation, deductibility of interest payments, absence of capital duty on share issues (in certain provinces only), entitlement to the benefit of tax treaties and the EU Parent/Subsidiary Directive and availability of advance rulings. But the special feature of Spain - and one not found anywhere else in the "participation exemption" countries - is an absence of withholding tax on the distribution of non-Spanish source dividends. This does not apply when the recipient is resident in a tax haven (*paraiso fiscal*); accordingly, when one is considering the investment needs of a zero-tax investor (typically, as I said in my earlier article, the individual living in Monte-Carlo or the trust established in the Cayman Islands) consideration may be given to holding the ETVE share through (for example) a Costa Rica company.

The United Kingdom legislation for the International Holding Company ("IHC")[7] proceeds quite differently from that of its continental counterparts - offering no reduction in the tax payable by the company on its income (nor, which is perhaps more serious, any reduction in the tax payable on its capital gains), but effectively eliminating tax on outgoing dividends. The prime use of the IHC, therefore, is in cases where there is sufficient credit for foreign taxes (including underlying taxes) to absorb the UK corporation tax charge on incoming dividends - e.g. where the holding is a direct investment is in a United States corporation. If there is a possibility that the investment may at some stage be sold at a profit, one way of avoiding corporation tax on the capital gain is to have two classes of shares in (in this case) the United States corporation, only the dividend-bearing ones being owned by the IHC.

I have no doubt that, even as - dear reader - you peruse these pages, some government department in Europe is contemplating some change in the law to facilitate the use of its country as a base for a holding company, and I have no doubt that, if I am asked to contribute another article to this *Review* in a further five years' time, there will be other changes to report.

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7 The IHC emerged unscathed from the proposed abolition of the special treatment for foreign income dividends announced in the Budget of the 2nd July.