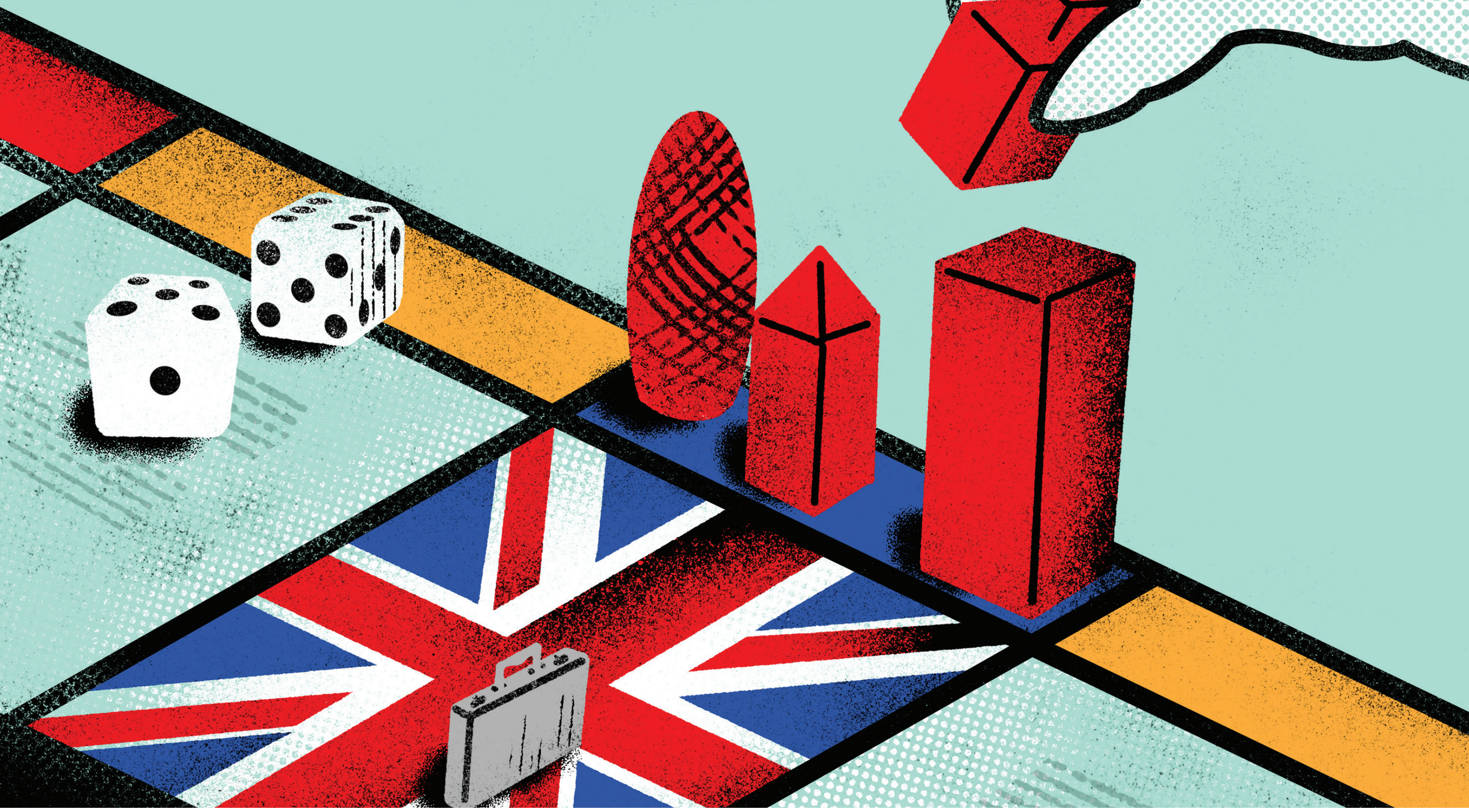

TAX EFFICIENCY OF HOLDING COMPANIES

HOLDING BACK THE FEARS

Oliver Walker and Eithne Bloice-Sanders of Weil, Gotshal & Manges (London) LLP examine recent developments that may affect the use of holding companies and the resulting impact on the UK as a holding jurisdiction.

There has been an abundance of tax measures in recent years that have the potential to reduce the tax efficiency of holding companies. For example, the European Court of Justice (ECJ) judgments in the Danish withholding tax cases (*see "The Danish cases" below*), the publication of the draft Anti-Tax Avoidance Directive (ATAD) III (the so-called "Unshell Directive"), and the European Commission's announcement that ATAD III will be closely followed by an anti-shell directive that will apply to non-EU companies, have led some to predict the demise of the use of holding companies in investment structures.

It is the authors' view that reports of such a demise are an exaggeration. However, there have been a number of recent developments that have the potential to disrupt the use of holding companies. This article provides an overview of the relevance of these developments to the UK as a viable holding company jurisdiction (*see box "Key European jurisdictions"*).

BEPS PROJECT

Base erosion and profit shifting (BEPS) refers to tax-planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to locations with no or low tax rates, or no or little economic activity, or both. The Organisation for Economic Co-operation and Development's (OECD) BEPS project (the BEPS project), which was commissioned by the G20 and published in 2013, brought about a significant shift in the tax climate for holding companies (*see News brief "The OECD's action plan on BEPS: a taxing problem", www.practicallaw.com/0-538-9745*).

BEPS actions

On 5 October 2015, the OECD published its final reports and explanatory statement outlining 15 BEPS actions and agreed recommendations (the BEPS actions) (*www.oecd.org/tax/beps/flyer-inclusive-framework-on-beps.pdf*). The BEPS actions are intended to:

- Tackle tax avoidance.
- Improve the coherence of international tax rules.
- Ensure a more transparent tax environment.

A complete description of each action is outside the scope of this article, but descriptions of certain actions are set out below, where relevant.

Key European jurisdictions

The UK, Luxembourg, Ireland and the Netherlands have historically been popular European holding company jurisdictions.

UK

Despite recent events, the UK has historically been considered to be an attractive holding company jurisdiction because of its relatively stable legal, political and economic system, an investor-friendly tax regime and an extensive tax treaty network, including with each member state. The key benefits of the UK tax system include:

- A broad corporate tax exemption, and the absence of withholding tax, on dividends.
- A participation exemption for certain corporate disposals.
- The quoted eurobond exemption in respect of withholding tax on interest payable on qualifying listed debt.

The introduction of the qualifying asset holding companies regime from 1 April 2022 provides a simplified basis of tax for UK holding companies for various types of investors, and includes broad tax exemptions for share disposals, interest payments and other tax benefits (*see box "The new QAHC regime"*). However, it remains to be seen how popular the new regime will be after an initial period of inertia, as investors and their advisers get to grips with its various intricacies.

The current headline rate of corporation tax in the UK is 19%. After a U-turn by the government, it has now been confirmed that the rate will increase to 25% from 1 April 2023 as originally proposed.

Luxembourg

Luxembourg has historically been an attractive holding company jurisdiction for international groups and investment funds, in part because of its competitive, transparent and stable tax system and wide network of double tax treaties. In particular, its participation exemption regime and the opportunity to eliminate or mitigate income tax and withholding tax on debt- and equity-based payments means that there are a number of tax-efficient ways to extract funds from Luxembourg. However, substance requirements have increased in recent years, with corresponding increases in travel by directors of Luxembourg holding companies. The ability to secure helpful advance tax rulings, once a common feature of structuring through Luxembourg, has been significantly curtailed.

Corporate income tax is generally charged at the headline rate of 17% plus a 7% solitary surcharge for the employment fund, resulting in an aggregate rate of 18.19% in Luxembourg. Municipal business taxes may also apply.

Ireland

Ireland can also offer competitive corporate tax rates to holding structures and an extensive network of double tax treaties. Generally, dividends can be paid free of withholding tax. Despite changes in recent years, including the elimination of the "double Irish" tax avoidance schemes in 2015 and the approval of an increase in the rate of corporation tax for companies with turnover in excess of €750 million by the Irish Cabinet in 2021, Ireland is generally viewed as a pro-business environment and continues to be a popular holding company jurisdiction.

In Ireland, corporation tax at the rate of 12.5% is generally charged on a company's trading income. As part of its agreement to join the OECD/G20 Inclusive Framework on BEPS (base erosion and profit shifting), the Irish 2022 Budget proposal confirmed the Irish government's commitment to introduce a 15% minimum corporation tax rate for companies with an annual revenue exceeding €750 million (*see "Pillar 2" in the main text*).

The Netherlands

The Netherlands tax system includes exemptions from withholding tax on dividends and interest, an extensive double tax treaty network and attractive participation exemption rules. However, in recent years, various substance requirements have found their way into Dutch tax legislation. Nevertheless, the Netherlands remains an attractive jurisdiction for holding companies, with the Dutch tax authorities remaining relatively accessible.

There are two corporate tax rates in the Netherlands:

- Taxable profits of up to €200,000 are generally subject to corporate tax at the rate of 15%.
- Taxable profits over €200,000 are generally subject to corporate tax at the rate of 21.7%.

Following the publication of the BEPS actions, and the implementation of some of them in the EU through the first ATAD (*2016/1164/EU*), the OECD and the G20 continued to undertake further work, bringing together a much larger group of countries than those involved in agreeing the original recommendations (*see News brief "Corporate tax avoidance and BEPS: the EU grasps the nettle", www.practicallaw.com/3-623-5185*). In 2016, the OECD/G20 Inclusive Framework on BEPS (the Inclusive Framework) was established to allow over 135 countries and jurisdictions to collaborate on the BEPS project. In January 2020, the Inclusive Framework adopted a two-pillar approach (*see "Two-pillar approach" below*).

UK policies on BEPS

Historically, the UK has been relatively proactive in countering tax avoidance and, in many cases, it has been ahead of the curve when it comes to actioning agreed BEPS policies. For example, the UK has had a controlled foreign company (CFC) regime in place since 1984, which was significantly updated by Finance Act 2012 (*see News brief "New CFC proposals: enhancing UK tax competitiveness?", www.practicallaw.com/1-517-3815*). In contrast, EU-wide CFC rules were only required to be transposed into domestic legislation by 31 December 2018, following the adoption of ATAD. As well as implementing tax avoidance rules in a timely manner, another UK trend has been the enactment of UK domestic legislation that goes further than the minimum standards required by the BEPS actions or, before Brexit, EU directives, as illustrated by the UK's approach to hybrid mismatches; that is, arrangements that exploit differences in the tax treatment of instruments or entities in two or more jurisdictions.

Preventing tax treaty abuse

One of the key actions arising from the BEPS project was Action 6: the prevention of tax treaty abuse (*www.oecd.org/tax/beps/beps-actions/action6*). Action 6 restricts access to double tax treaties through the implementation of a minimum standard that requires jurisdictions to include provisions dealing with "treaty shopping" in their tax treaties. Treaty shopping typically means moving funds through an entity with a main purpose of obtaining treaty benefits that would not otherwise be available in the absence of that entity. Action 6 therefore sets a higher bar for holding companies seeking to benefit from withholding tax exemptions. So far, a large majority of Inclusive Framework members have modified, or are in the process of modifying, their treaties to comply with Action 6 (*see "Treaty abuse" below*).

ATAD standards

In order to implement a number of recommendations arising from the BEPS actions across the EU, the Council of the EU formally adopted ATAD on 12 July 2016. Its aim is to provide a minimum level of protection for the EU's internal market and to ensure a harmonised approached in relation to BEPS. ATAD II (*2017/952/EU*) was adopted on 27 May 2017 (*www.practicallaw.com/w-008-7849*). ATAD II broadened the original scope of ATAD to deal with hybrid mismatches and is outside the scope of this article.

ATAD provides minimum standards for anti-avoidance in five areas.

Limitation on the deduction of interest. Deductions in respect of corporate interest expenses must be limited to no more than 30% of taxable earnings before interest, tax, depreciation and amortisation (Action 4). This is often referred to as the corporate interest restriction (CIR).

General anti-abuse rule (GAAR). Arrangements will be counteracted or set aside where one of the main purposes of the arrangements is to obtain a tax advantage (Action 6).

CFCs. CFC rules are anti-avoidance provisions designed to prevent the artificial diversion of profits to low-tax jurisdictions. Tax must be imposed on the profits of CFCs based on two options: the taxation of undistributed income of CFCs, unless the CFC carries on substantive economic activity supported by employees, assets and premises; or the taxation of undistributed income streams arising from non-genuine arrangements that have been put in place to achieve a tax advantage (Action 3).

Anti-hybrid measures. Taxpayers should be prevented from obtaining a tax advantage arising from a mismatch in tax treatment that results in either the obtaining of a double deduction for the same expense in more than one jurisdiction or where a deduction is not matched by an inclusion elsewhere (Action 2).

Exit taxation. Exit charges must be imposed where assets leave a country's tax net but remain under the ownership of the same taxpayer; for example, on migration of a company's residence. This standard goes beyond the scope of BEPS.

UK ATAD-equivalent standards

Despite Brexit, the UK has implemented standards that are equivalent to those in ATAD. However, the impact on UK holding companies has been varied, with the UK complying with the requirements of ATAD in the following ways:

- To comply with ATAD and the underlying BEPS actions, the UK published CIR rules in 2017, which took effect from 1 April 2017 (with subsequent, relatively minor amendments) (*see News brief "Spring Budget 2017: key tax measures for businesses", www.practicallaw.com/8-640-1163*).

- The UK's GAAR has generally applied since 17 July 2013, so no significant changes were required in relation to this minimum standard (*see feature article "General anti-abuse rule: casting a wider net", www.practicallaw.com/1-545-4146*).

- The UK has had some form of CFC rules since 1984 and, following significant amendment in respect of accounting periods beginning on or after 1 January 2013, the UK CFC rules were already consistent with the approach required by ATAD (*see "UK policies on BEPS"*).

- The UK introduced comprehensive anti-hybrid rules in the Finance Act 2016, which came into effect from 1 January 2017. The majority of these rules already met or exceeded the minimum standards required by ATAD, although two minor changes were introduced in the Finance Act 2018, which relate to the specific requirements of ATAD in respect of the treatment of certain mismatches involving permanent establishments and the exemption of regulatory capital (*see News brief "Autumn Budget 2017: keeping pace with change?", www.practicallaw.com/w-011-6628*).

- The UK had existing rules in relation to corporation tax exit charges, although changes were introduced from 1 January 2020 which, among other things, amended the rules for corporation tax exit charge payment plans and repealed the rules that provided for the postponement of exit charges.

The most significant change brought about by ATAD in the UK was perhaps the enactment of domestic CIR rules and, although there are various approaches permitted by the legislation that may minimise the impact of the CIR rules, the UK's version of the rules actually goes beyond the minimum standard contained in Action 4. However, the UK's CIR rules are broadly in line with those of other EU jurisdictions, so the UK is perhaps not at a material disadvantage in this regard. In reality, many investors looking to structure transactions through a European holding structure have come to terms with the possibility of reduced interest deductibility, with shareholder debt increasingly seen by some primarily as a cash repatriation tool.

TWO-PILLAR APPROACH

The continued work of the Inclusive Framework led to the adoption of a two-pillar approach in January 2020 (*www.oecd.org/tax/beps/statement-by-the-oecd-g20-inclusive-framework-on-beps-january-2020.pdf*). Pillar 1 includes solutions for determining the allocation of taxing rights and Pillar 2 ensures that multinational enterprises (MNEs) pay a minimum level of tax on profits.

Pillar 1

Pillar 1 targets MNEs with a global turnover above €20 billion and it is expected to apply to about 100 of the biggest and most profitable MNEs. Its aim is to reallocate part of these MNEs' profits to the countries where they sell products or provide services. The OECD published a progress report on 11 July 2022, confirming that:

- Stakeholder feedback on the progress report was to be sought by 19 August 2022.
- The Inclusive Framework will review the feedback and seek to stabilise the rules at its meeting in October 2022.
- A multilateral convention is expected to be signed by Inclusive Framework members in the first half of 2023 with the objective of it entering into force in 2024 (*www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf*).

Pillar 1 is not considered further in this article.

Pillar 2

Under Pillar 2, MNEs with an annual revenue above €750 million would be subject to a global minimum corporate tax rate of 15%. Briefly, Pillar 2 aims to achieve this through:

- The implementation of two domestic global anti-base erosion rules (GloBE rules):
  - a top-up tax payable by parent entities on low-taxed income of their subsidiaries (the income inclusion rule (IIR)); and
  - an undertaxed payment rule (UTPR) denying certain deductions.
- A treaty-based subject to tax rule (STTR), which allows jurisdictions to impose source taxation (that is, withholding tax) on certain related party payments that are subject to tax below a minimum rate.

Somewhat ambitiously, Pillar 2 was due to be brought into law in 2022 and to take effect from 2023, except for the UTPR which was expected to come into effect in 2024. However, the government announced in June 2022 that the effective date of the Pillar 2 legislation in the UK will be delayed, and will now apply from 1 April 2024 (*https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1045663/11Jan_2022_Pillar_2_Consultation_.pdf*). The government published draft legislation on 20 July 2022, which was open for comment until 14 September 2022 (*www.gov.uk/government/publications/introduction-of-the-new-multinational-top-up-tax*).

IIR and UTPR. In summary, the IIR will require a parent entity that is headquartered in a jurisdiction which has a set of domestic rules equivalent to the Pillar 2 model rules to pay additional tax in respect of any income of its subsidiaries that is subject to tax at a rate of less than 15%. The UTPR permits the jurisdiction in which income arises (the source jurisdiction) to collect any additional top-up tax from group companies in that jurisdiction by denying these entities tax deductions for payments that they make or by making equivalent adjustments. The computations required in order to assess the applicable rate of tax for the purposes of Pillar 2 may not align exactly with the existing method currently used in a given jurisdiction under domestic rules. As a result, some companies may be surprised to discover that their applicable rate of tax for these purposes falls short of the 15% minimum rate.

STTR. The STTR is a treaty-based rule that specifically targets risks to source jurisdictions relating to intra-group payments that take advantage of low rates of taxation in other contracting jurisdictions; for example, the jurisdiction of the recipient of the payment (the recipient jurisdiction). There are two requirements for a source jurisdiction to include the STTR in its treaty with another jurisdiction; that is, the jurisdiction where the beneficial owner of the payment is resident for tax purposes:

- The source jurisdiction's gross national income per capita was $12,535 or less in 2019.
- The recipient jurisdiction's nominal corporate tax rate applicable to payments such as interest and royalties is less than the STTR minimum tax rate, which is currently 9%.

Where the STTR applies, treaty relief that would otherwise have been provided may be denied, therefore undermining treaty benefits that would usually be expected to be available. The amount of source jurisdiction tax is capped at the difference between the minimum rate and the nominal corporate tax rate that is applicable to the payment in the recipient jurisdiction.

The source jurisdiction, if the STTR has been enacted bilaterally, may apply withholding tax at a maximum rate of 7.5% to 9%, depending on the minimum level of tax in the recipient jurisdiction.

It is not anticipated that the STTR will be introduced into any of the UK's tax treaties because, under the Pillar 2 framework, countries will be required to introduce the STTR in their treaties with developing countries only when requested to do so by the other party and only if they apply tax rates below 9% to "covered payments". "Covered payments" include interest and royalties, and other payments that present BEPS risks because they arise in respect of mobile risk, ownership of assets, or capital, such as franchise fees, insurance premiums, guarantee or financing fees, and rent.

Under current proposals outlined in a joint Treasury and HM Revenue & Customs (HMRC) consultation, which was published on 11 January 2022, the IIR will impose a top-up tax on MNEs that are headquartered in the UK and certain intermediate UK parent companies of non-UK headquartered groups, based on their interests in overseas subsidiaries and branches that are located in jurisdictions in which the MNE has an effective tax rate below 15% (*see Focus "OECD Pillar Two model rules: moving closer to a global minimum tax", www.practicallaw.com/w-034-5157*).

The UTPR should then apply only to UK entities within non-UK headquartered groups in certain circumstances when the MNE's ultimate parent entity is not subject to an IIR, even though there are low-taxed entities within the group.

While the rate of corporation tax in the UK is 19%, the UK is also considering introducing a domestic minimum tax to ensure that additional tax on UK economic activities and profits arising under the Pillar 2 framework is to the benefit of the UK Exchequer.

DOUBLE TAX TREATIES

Double tax treaties have been subject to significant amendments in recent years, which has affected the extent to which holding companies can rely on them to minimise or eliminate double taxation. The UK has long been party to a global network of bilateral tax treaties, and the use of these treaties in eliminating double taxation and allocating taxing rights has been a significant factor in the popularity of the UK as a holding company jurisdiction. The UK retains an extensive double tax treaty network and could be considered a global leader in this regard.

However, there have been two key changes in this area:

- The restriction of treaty benefits for abusive arrangements, such as the interposition of a holding company with the main purpose of obtaining treaty benefits.

- For member states, the requirement to have sufficient substance in order to access treaty reliefs.

OECD multilateral instrument

Double tax treaties are often critical for the efficient repatriation, extraction and movement of funds and payments (usually) up an investment holding structure. Where domestic exemptions do not apply, double tax treaties often permit interest or dividends, or both, to be paid to group companies or to investors without, or at a reduced rate of, withholding tax.

In November 2016, over 100 jurisdictions agreed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which allows governments to close gaps in existing international tax rules by implementing tax treaty proposals developed during the BEPS project (*www.oecd.org/tax/beps/beps-actions/action15/#d.en.521955*). It modifies the application of thousands of bilateral tax treaties and reflects three BEPS actions, the most relevant of which for holding companies is Action 6 relating to the prevention of tax treaty abuse (*www.oecd.org/tax/beps/explanatory-statement-multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf*). The UK signed the MLI in 2017 and it entered into force in 2018, having effect for UK tax treaties from 2019.

Treaty abuse

The OECD published a report on the prevention of treaty abuse (BEPS Action 6 report) on 14 February 2019 (*www.oecd.org/tax/beps/prevention-of-treaty-abuse-peer-review-report-on-treaty-shopping-9789264312388-en.htm*). The BEPS Action 6 report includes three alternative rules to address treaty abuse:

- A GAAR based on the principal purpose of transactions or arrangements (the principal purpose test (PPT)) (*see box "Principal purpose test"*).

- A simplified limitation on benefits (LOB) provision.

- A detailed LOB provision.

The BEPS Action 6 report states that countries should, as a minimum, implement one of the following:

- A PPT only.

- A PPT combined with a LOB provision.

- A detailed LOB provision.

The MLI does not contain a detailed LOB provision since it would require substantial bilateral customisation by the relevant parties to the double tax treaty; instead, a PPT is presented as the default option. Most countries, including the UK, Ireland, Luxembourg and the Netherlands, have

Principal purpose test

The principal purpose test (PPT) was one of the key changes introduced by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (*see "Treaty abuse" in the main text*). Broadly, the PPT allows tax authorities to disallow the application of treaty benefits in certain situations.

The PPT has the effect of denying treaty benefits if, having regard to all of the relevant facts and circumstances, it is reasonable to conclude that obtaining the treaty benefit was one of the principal purposes of an arrangement or transaction that directly or indirectly resulted in that benefit. As an exception to this rule, if granting the benefit would be in accordance with the object and purpose of the relevant provisions, the treaty benefit will not be denied.

The discussion draft published by the Organisation for Economic Co-operation and Development (OECD) in March 2014 in relation to base erosion and profit shifting (BEPS) Action 6 noted that, if an arrangement was undertaken as part of a core commercial activity, and it was not driven by tax considerations or by obtaining a reduction in tax, it is unlikely that its principal purpose was obtaining a treaty benefit (*www.oecd.org/tax/treaties/treaty-abuse-discussion-draft-march-2014.pdf*) (*www.practicallaw.com/4-565-5049*). In paragraph 181 of the OECD commentary on Article 29 of the Model Tax Convention on Income and on Capital 2017, this guidance was amended to say that where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit (*https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_8cc997e9-en#page89*).

The UK has added a PPT to its network of double tax treaties and therefore treaty benefits will be denied to certain arrangements. As this is a subjective test, and HM Revenue & Customs (HMRC) may take a different view of what is "reasonable to conclude" compared to the taxpayer, it is fair to say that there is room for a degree of uncertainty.

In its recent judgment in *Burlington Loan Management DAC v HMRC*, the First-tier Tribunal held that the assignment of a debt (owed by a UK resident company) by a Cayman lender to an Irish-resident company did not have a main purpose of taking advantage of the interest article in the UK-Ireland double tax treaty, and therefore the Irish-resident company could benefit from the treaty exemption from withholding tax on interest (*[2022] UKFTT 290 (TC); www.practicallaw.com/w-037-0296*). This is the first case in the UK courts that interprets a main purpose test in a double tax treaty and, although it was highly fact-specific, it may well influence the future interpretation of the PPT. It remains to be seen whether HMRC will seek permission to appeal to the Upper Tribunal.

chosen to implement a PPT only, but notably the US favours a detailed LOB provision supplemented by an anti-conduit rule.

Until recently, it was increasingly common for commercial credit facilities between companies to place any change-in-law risk arising from the implementation of the MLI on the lender. In other words, the borrower would not be required to gross up payments of interest for any tax required to be withheld following a subsequent implementation of the MLI. Any other change-in-law risk would generally remain with the borrower. Given that around 80 countries have now ratified the MLI, it is less common in practice to carve out changes arising from the implementation of the MLI.

Recent UK cases

There have been a number of recent cases in the UK courts that have resulted in UK companies being prevented from benefitting from interest deductions, specifically in the context of a domestic targeted anti-avoidance rule. Broadly speaking, a UK company may not claim deductions for interest that is attributable to an "unallowable purpose"; that is, it is not among the company's commercial or business purposes.

In *Kwik-Fit Group Ltd and others v HMRC*, the First-tier Tribunal held that the only reason the Kwik-Fit Group incurred additional interest expense, by increasing the interest rate on certain intra-group loans but not others, was to secure tax advantages in the form of interest deductions (*[2021] UKFTT 283 (TC); www.practicallaw.com/w-033-0972*). This was a main purpose of the arrangements and, therefore, an unallowable purpose. As a result, the tribunal denied deductions for the interest expense. The Kwik-Fit Group's appeal was heard before the Upper Tribunal in September 2022. At the time of writing, the judgment has not yet been handed down.

In *JTI Acquisition Company (2011) Ltd v HMRC*, the First-tier Tribunal held that JTI Acquisition Company was party to a loan relationship to secure a tax advantage and disallowed interest payments amounting to over £40 million (*[2022] UKFTT 166 (TC); www.practicallaw.com/w-036-0413*). The tribunal held that related transactions should also be considered and the reason for the funding arrangement should be looked at as a whole. The loan relationship had no genuine commercial purpose and the main purpose of becoming a party to the loan relationship was to secure a tax advantage.

In *HMRC v BlackRock Holdco 5 LLC*, the Upper Tribunal held that loan relationship debits claimed as part of an intra-group financing arrangement were wholly attributable to an unallowable purpose (*[2022] UKUT 00199 (TCC); www.practicallaw.com/w-036-6556*). The tribunal applied a "but for" test; that is, but for the tax advantage, the tribunal concluded that BlackRock Holdco 5 would not have existed, no loan notes would have been issued to its US-resident parent, and therefore no debits would have arisen. Commentators expect that BlackRock may seek permission to appeal. If so, it will be interesting to hear the Court of Appeal's view on the unallowable purpose rule.

The Danish cases

In landmark rulings that had a wide and significant impact for structures using cross-border EU holding companies, the ECJ found that the use of holding companies in jurisdictions within the EU can amount to an abuse of EU rights in some circumstances. The ECJ handed down its judgments in February 2019 in *Skatteministeriet v T Denmark and Y Denmark Aps* (*Joined Cases C-116/16 and C-117/16*) (the dividend cases) and in *N Luxembourg 1, X Denmark A/S, C Denmark I and Z Denmark ApS v Skatteministeriet* (*Joined Cases C-115/16, C-118/16 , C-119/16 and C-299/16*) (the interest cases).

The issues were:

- Whether dividend and interest payments could benefit from an exemption from withholding tax under the Parent-Subsidiary Directive (*2011/96/EU*) or the Interest and Royalties Directive (*2003/49/EC*) when the payments were made from a Danish company to a company that was resident in an EU member state, which were then fully or partially passed on to an ultimate parent company residing in a third country.

- Whether the intermediate company was the beneficial owner of the interest payments.

The Parent-Subsidiary Directive broadly provides that an EU company can pay dividends free of withholding tax to a parent company with a minimum 10% shareholding. The Interest and Royalties Directive provides that there is no withholding tax on interest and royalty payments by an EU company to an "associated company"; that is, an EU company with a 25% direct shareholding or an EU company where a third EU company has a direct 25% shareholding in both companies.

The dividend cases. The dividend cases involved payments of dividends by a Danish company to other group companies established in other member states, but the ultimate shareholder of the group was a US listed company. By way of an intra-group restructuring, a company incorporated in Cyprus was interposed between the Danish company and its immediate parent company, which was incorporated in Bermuda. The Cypriot company had no staff, office or other business activities. Dividends were paid to the Cypriot company, which were eventually passed on to its parent. Although the Parent-Subsidiary Directive does not have a beneficial ownership test in relation to dividend payments, the ECJ agreed with the Danish tax authorities that group entities that are established purely with the objective of obtaining a tax advantage should not be entitled to rely on the Parent-Subsidiary Directive to exempt dividends from withholding tax.

The interest cases. Private equity funds set up a stack of Luxembourg and Danish companies to acquire a Danish company, which was partly financed by a loan from the funds to the Danish acquisition company. Following a group reorganisation, the debt was acquired by a Luxembourg company, financed by back-to-back loans ultimately from the funds. The Danish acquisition company paid interest to the Luxembourg company without withholding tax. The ECJ was asked whether the Luxembourg company, as the recipient of the interest, was the beneficial owner of that interest and therefore could benefit from the withholding tax exemption in the Interest and Royalties Directive. The ECJ held that the term "beneficial owner" of the interest means the entity that benefits economically from the interest and left room for the national courts to look through the back-to-back loans in determining the beneficial owner of the interest payments.

Impact of the Danish cases. In delivering its judgments, the ECJ provided further guidance on abusive arrangements. For example, if funds are passed on shortly after they are received, the ECJ stated that this could, in some cases, indicate that the entity is a conduit and that the arrangement is potentially abusive. A further indicator of abuse includes a recipient that lacks substance.

Following these cases, there has unsurprisingly been an increased focus on the concept of beneficial ownership, particularly in the context of reliance on directives and double tax treaties, and a consequent need for multinational groups to ensure sufficient substance at the level of the recipient of the payment for which an EU directive or double tax treaty is being relied on.

As to what constitutes "sufficient substance", draft ATAD III legislation, published in December 2021, provides the directors of companies in member states with objective criteria against which to measure the activities of group companies in order to determine whether they have sufficient substance (*see "Draft ATAD III" below*).

The new QAHC regime

Broadly, a company is a qualifying asset holding company (QAHC) if it meets the following conditions:

- It is UK tax-resident.
- It meets the ownership condition; that is, interests held by investors other than certain QAHCs, qualifying funds, qualifying investors, intermediate companies and public bodies do not exceed 30%.
- It meets the activity condition; that is, the main activity of the company is carrying on an investment business.
- It meets the investment strategy condition; that is, the QAHC's investment strategy does not involve the acquisition of listed or traded securities.
- It is not a UK real estate investment trust.
- No equity securities of the company are listed or traded on a recognised stock exchange, or any other public market or exchange.
- It has made and submitted to HM Revenue & Customs an entry notification to be a QAHC.

Broadly, the tax benefits of being a QAHC are that:

- Certain income and gains of the QAHC are exempt from tax.
- Deductions are available for interest as it arises that would not otherwise be available.
- There is no obligation to withhold tax on interest payments.
- Capital treatment of gains returned to investors through a buyback or redemption of the QAHC's shares is available, with no stamp duty or stamp duty reserve tax payable on the buyback.

UK decisions

Before the Danish cases, the Court of Appeal in *Indofood International Finance Ltd v JP Morgan Chase Bank NA, London Branch* considered the meaning of beneficial ownership in the context of the payment of interest to a Dutch company that was interposed in the structure as a means of accessing treaty benefits (*[2006] EWCA Civ 158; www.practicallaw.com/7-202-2902*). The court held that an "international fiscal meaning" should be given to the words "beneficial ownership". The court relied on the OECD's commentary on Article 10 of the Model Tax Convention on Income and on Capital 2017, which states that the term "beneficial owner" should not be interpreted narrowly, but should be understood in its context and in accordance with the purpose of the convention, including avoiding double taxation and preventing fiscal evasion and avoidance.

The structure in *Indofood* included a Mauritian subsidiary, which reduced withholding tax leakage through the Indonesia-Mauritius double tax treaty until a change in law removed the relevant treaty benefits. Reflecting the importance and impact of the judgment, HMRC substantially updated its guidance to include commentary on the impact and application of *Indofood* (*www.gov.uk/hmrc-internal-manuals/international-manual/intm332000*).

More recently, in *Hargreaves Property Holdings Ltd v HMRC*, the First-tier Tribunal held that relief from withholding tax under the UK-Guernsey double tax treaty was unavailable (*[2021] UKFTT 390 (TC); www.practicallaw.com/w-034-1879*). A property investment group restructured its loans, with each lender assigning its right to interest to a Guernsey-resident entity, and again to a UK tax-resident company, shortly before it was due. The Hargreaves borrower entity did not withhold tax from interest payments, claiming in one of its arguments before the tribunal that it had the benefit of either relief under the UK-Guernsey double tax treaty or a domestic law UK-to-UK exemption was available for interest paid to a UK tax-resident company.

The tribunal held that the UK tax-resident company, to which the right to interest had been assigned, was not beneficially entitled to the interest it received on the basis that it was required to pay another group company an amount for the assignment of that right to interest. In the tribunal's view, assigning the right to interest to a UK tax-resident company shortly before the interest was paid had no commercial purpose; the UK tax-resident company was not the beneficial owner of the interest and, therefore, the withholding tax exemption in domestic law did not apply.

SUBSTANCE REQUIREMENTS

Another major development in recent years has been the increased requirement for holding companies to have sufficient substance in the jurisdiction in which they are tax-resident. In particular, this will often tie in with the question of beneficial ownership and whether each company within a holding structure has a commercial purpose.

Draft ATAD III

Draft ATAD III, which is also referred to as the Unshell Directive, was published in December 2021. Draft ATAD III targets EU tax-resident companies that have passive income and inadequate operational substance. Under the proposals, the benefits of tax treaties and EU directives may be denied to the extent that minimum substance requirements are not met. This would increase the withholding tax burden as well as give rise to potential penalties for taxpayers that fail to report or incorrectly report specified information in their tax returns.

Although member states will be required to apply the proposals by 1 January 2024, there is a two-year look-back period. Therefore, many EU-resident holding companies will likely be taking steps now to analyse whether they fall within the rules.

When draft ATAD III comes into force, an EU company will be required to report:

- More than 75% of its revenues in the previous two years is mobile or passive income.
- It carries out cross-border activities.
- In the previous two years, it outsourced its day-to-day operations and decision making.

If a specific exclusion does not apply, or the company is not granted an exemption from reporting, it must declare in its tax return whether it meets minimum substance requirements. These are that the company has office space and at least one active bank account in the EU, and that either the majority of the company's employees, or at least one director, is:

- Resident in, or lives close to, the jurisdiction of the company.
- Appropriately qualified.

Although additional clarity on the meaning of "substance" is helpful, if a company falls within the scope of draft ATAD III, it may still rebut the presumption of inadequate substance. Non-EU entities, including UK companies, are not within the scope of draft ATAD III. However, the EU has announced plans to apply additional proposals to non-EU shell entities and, on 11 July 2022, the European Commission (the Commission) consulted on proposals that are designed to prevent intermediaries from providing tax advisory services in relation to certain tax arrangements in non-EU countries that lead to tax evasion or aggressive tax planning in member states (*https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13488-Tax-evasion-aggressive-tax-planning-in-the-EU-tackling-the-role-of-enablers_en*). More detailed proposals are expected in late 2022 or early 2023, with the aim of adopting the proposals across the EU by the first quarter of 2023.

Details of the scope of the follow-up directive to ATAD III are not included within the Commission's consultation but there is a risk that, if certain substance requirements are not met, non-EU entities, including UK holding companies, may not be able to benefit from double tax treaties with member states. However, given that the legislation and case law discussed in this article have already, in many cases, forced holding companies to increase their substance, it remains to be

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IMPACT OF BREXIT

The UK left the EU at midnight on 31 January 2020. Before then, in addition to any available double tax treaties, UK companies could rely on two EU directives to eliminate withholding taxes: the Parent-Subsidiary Directive and the Interest and Royalties Directive. As the UK is no longer a member state, these directives will no longer apply to EU companies that pay dividends or interest to UK entities. Instead, EU companies will look to domestic rules or the relevant double tax treaty with the UK.

Brexit did not bring about any change for UK companies that pay dividends to non-UK shareholders as, under domestic rules, the UK does not impose a dividend withholding tax. However, outbound interest payments are subject to the deduction of income tax at source, which is currently set at the rate of 20%, unless the rate of withholding tax can be reduced to nil under a double tax treaty or a domestic exemption applies. The legislation and case law described above in relation to treaty abuse, the PPT and beneficial ownership, is likely to still be relevant and important for UK holding companies despite Brexit (*see also box "Recent UK cases"*).

UK legislation contains a number of domestic exemptions from withholding tax, which can often be more useful than relying on treaty relief, particularly given the current delays in responses from HMRC for applications, whether under the simplified double tax treaty passport scheme or otherwise (*www.practicallaw.com/3-535-1265*) (*see box "Key European jurisdictions"*). The key domestic exemptions include the qualifying private placement exemption, the quoted eurobond exemption and the newly enacted qualifying asset holding companies (QAHC) regime (*see box "The new QAHC regime"*).

LOOKING AHEAD

A key consideration in the planning of an investment structure is the minimisation of tax leakage as funds are returned to investors. It is important that a structure for multiple investors is, where possible, no less tax-efficient than a direct holding. Access to domestic exemptions from tax, double tax treaties and EU directives is therefore critical.

Pure conduit companies and low substance special purpose vehicles are increasingly losing favour in tax-planning structures and, given the EU's proposal for a non-EU anti-shell directive, any attempt to use non-EU shell companies to circumvent the ATAD III rules may be short-lived (*https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_6968*).

Despite the torrent of domestic and international measures in recent years that have had an impact on the functionality of UK holding companies, it is unlikely that these measures, even when considered as a whole, will result in a significant exit of multinational groups from the UK or a departure from the UK as a holding jurisdiction. In addition to the various favourable tax rules at play in the UK, the introduction of the new QAHC regime is expected to encourage and facilitate the use of UK holding structures by certain institutional investors and funds.

UK holding companies will be holding on for a while yet.

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