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Holding company as a special form of tax optimization used in selected european countries

Spółka holdingowa jako szczególna forma optymalizacji podatkowej wykorzystywana w wybranych państwach europejskich

Abstract

The subject-matter of the article is a holding company used by entities with cross-border capital links. Employment of this mechanism is a significant solution adopted in tax optimization strategies. The tax effectiveness of this solution is closely connected with certain tax jurisdictions in Europe. Undoubtedly, it is an innovative hybrid solution. This article analyses the multifaceted nature of the practice of using a holding company. The specific nature of the tax legislation applicable in individual European countries (with particular attention paid to tax havens) is of key importance for the tax effectiveness of a holding company.

Key words: international tax law, tax planning, holding company

JEL: K22, K33, K34

Streszczenie

Przedmiotem artykułu jest spółka holdingowa wykorzystywana przez podmioty powiązane kapitałowo transgranicznie. Wykorzystanie tego mechanizmu jest istotnym rozwiązaniem wykorzystywanym w strategiach optymalizacji podatkowej. Efektywność podatkowa tego rozwiązania jest ściśle związana z wybranymi jurysdykcjami podatkowymi w Europie. Niewątpliwie jest to rozwiązanie nowatorskie i mające charakter hybrydowy. W artykule poddany został analizie wieloaspektowy charakter wykorzystywania spółki holdingowej. Specyfika ustawodawstw podatkowych w poszczególnych państwach europejskich (ze szczególnym uwzględnieniem rajów podatkowych) będzie miała kluczowe znaczenie dla efektywności podatkowej spółki holdingowej.

Słowa kluczowe: międzynarodowe prawo podatkowe, planowanie podatkowe, spółka holdingowa

Introduction

In times of globalisation as well as the increasingly and actively developing tax competition, there is a vivid ongoing debate focusing on the tax law on holding companies. Holding companies are originators of international tax avoidance while, on the other hand, generating substantial profits subject to taxation.

There are countries that offer privileges only to certain types of economic entities (*e.g.*, holding companies) or undertakings despite their categorization as tax jurisdictions that impose high taxes. These are the so-called special tax havens, such as the Netherlands, Luxembourg, and Ireland.

As the process of globalization evolves, entrepreneurs find it especially appealing, if not necessary, to conduct business activities in various markets in many states. Therefore, the issue of the tax optimization of the investments accompanying cross-border cash flows is also gaining popularity in the context of planning operationally and financially effective holding structures.

A holding company plays a major role in optimizing the taxation of holding structures, which is achieved through tax havens. The effectiveness of this instrument largely depends on being able to successfully maneuver holding structures through European tax jurisdictions. Holding companies are used not only in tax havens but also in other European states.

The very institution of a holding company should also become an object of analysis, both on the part of the

European Commission and on that of individual European Union member states, in the context of possibilities of its comprehensive regulation.

Holding company

A holding company has become one of the key tax optimization instruments used by international groups of companies, both on the territory of the European Union, and in countries on other continents, considered as tax havens.

A holding company is a significant tax instrument employed to optimize taxation. A holding company is a company whose most important function is to hold shares in other companies. Such a company usually does not manufacture any goods or render any services. Holding companies, however, allow shareholders to exercise control over companies within a given group. It would be difficult, however, to point to the single best holding company in any given tax jurisdiction — one suitable for every international investment planned. When evaluating the usefulness of a foreign holding company, both tax-related and other factors must be taken into account.

Holding companies are frequently offered preferences because countries have a great deal of freedom to shape their domestic legal and tax systems (Endres, Schreiber, Dorfmueller, 2006, p. 46). Consequently, some states are attractive to foreign investors, who create holding companies in line with those states' laws. States that offer advantageous tax rules to holding companies are referred to as tax havens or as countries engaged in harmful tax competition.

An array of factors must be considered when deciding which jurisdiction to choose for a holding company or investment, not limited to merely selecting a country that offers a preferential tax status for such companies and investments, or even no taxation, which is possible in tax havens.

First, one must ensure that the method of locating a holding company's capital in a selected state will not entail the obligation to pay a tax on the initial transfer.

It is equally important to ensure an effective redistribution of assets along with the earned profit. Frequently, profit transfers, which are beneficial in terms of taxation by the state of an investor's residence, result in the need to pay tax at the transfer (O'Donnell, 2006, 43). Consequently, the advantage created by the choice of jurisdiction is limited to deferring the moment of taxation, not avoiding tax.

Indeed, even if a given country truly permits the minimization of taxation of income generated from investments made on its territory, it does not mean that the income distributed from that country will not be taxed by the state of an investor's tax residence.

Most of the developed, classic tax jurisdictions have devised various mechanisms to prevent tax avoidance and in particular, mechanisms that limit the possibilities of locating profits in preferential jurisdictions through special purpose vehicles, including holding companies (Schaffner, 2006, p. 39).

Thus, when planning a foreign investment, potential entrepreneur may not be content with choosing a state that imposes no taxes, but instead must also consider an array of factors that limit the possibility of obtaining real benefits from the investment.

The most important dilemma in planning investments is which type of investment is advisable from taxation perspective. An investor interested in making business in a given jurisdiction may establish a company for this purpose or, alternatively, may purchase an existing enterprise.

Frequently, to obtain better tax effects, it is worth "placing" an intermediary link between an investment (especially a purchased company) and the investor — the link might be a company situated in a country allowing profit transfers at low tax rates and ensuring investors' free access to funds. In principle, this is the primary purpose of using a holding company situated in a beneficial tax jurisdiction.

An appropriately constructed management structure allows for optimization of general operational costs. A cleverly designed and implemented holding structure, combined with a correctly implemented system of supervision exercised by the holding company, makes it possible to obtain substantial benefits, both for the entire group and for the individual companies involved. The benefits may be of economic character (allowing for, *e.g.*, functional or organizational optimization) or they may result from tax savings. The extent and type of tax benefits which may be achieved by designing a holding structure are heavily dependent on the particular type of business activity run by individual companies and on the business's flexibility in selecting locations for subsidiaries.

Currently, intensifying competitiveness forces entrepreneurs to consider optimization of financial flows more seriously when planning global activity, whereas these flows, in turn, are considerably influenced by tax-liability optimization.

On the other hand, a growing competition among states may be observed with respect to attracting foreign investors. It is increasingly common for countries to offer an array of incentives that make locating a company in a given jurisdiction more attractive due to the possibility of achieving substantial tax savings for the entire group (Chetcuti Dimech, 2006, p. 8). Frequently, the benefit is so enormous that it influences a holding company's business objectives. Indeed, obtaining this benefit often becomes one of the chief objectives when forming the organizational structure of a holding company.

Finally, one should remember that the shape of a holding structure will be considerably influenced by the final investors' business objectives, needs, and expectations. In principle, one of the most desirable tax benefits that should be achieved by an appropriately designed structure is the minimization of tax liability imposed on distributed profit. Reduction in effective taxation, although very important, is not the sine qua non of any structure. Investors often decide to bear the costs of an additional tax burden resulting from establishing a holding company because of the practical uses of such a company.

Tax Effects Produced by Holding Companies

Significant elements speaking in favor of using the instrument of a holding company are tax benefits that can have quite a varied character, depending on a number of factors.

In essence, the desirable tax effect of using a holding company is the elimination (or minimization) of taxation of capital gains from dividends and income from the disposal of operational companies' shares.

Initially, it might seem that both of these aims may be achieved by using a holding company situated in a so-called classic tax haven. Although it is usually the case that both received dividends and income from share disposal are not taxed in a tax haven, they may still be subject to taxation in the source state. This is because most EU Member States have introduced an array of restrictions on payments made to tax havens in an attempt to counteract so-called harmful tax competition. One of those restrictions is a high withholding tax on payments made to havens. Frequently, states also reserve the right to impose tax on income from the sale of assets situated on their territory (including shares in companies registered in their territories). Another way to secure income — not by a source state, but by the state where the investor is located — is to introduce a rule concerning the consolidation of foreign subsidiaries' incomes for tax purposes (the so-called CFC rules). In the case of many "non-haven" jurisdictions, such disadvantageous fiscal mechanisms are eliminated in AADTs. However, because classic tax havens are rarely signatories of AADTs, the possibility of producing an optimum tax effect by using a holding company situated in a tax haven is limited. In practice, using a tax haven as a holding-company jurisdiction is rarely advisable. Such jurisdictions are usually used for specific — often one-time — transactions or, increasingly often, for reasons unrelated to taxes.

To ensure that cash flows between a holding company and its subsidiaries are not subject to withholding tax (or that this tax is as low as possible) or other anti-haven restrictions, a holding company should be situated in a so-called treaty state, i.e., one that has concluded a large number of agreements to regulate issues connected with the avoidance of double taxation (Lener, 2000, p. 29). If a holding company is entitled to treaty protection (i.e., if it is considered a resident of a state-party to an agreement), an entity making payments to this company will have the right to use a preferential tax rate based on the appropriate treaty.

A holding company's investments may enable reduction in the effective taxation of the profit transfer to the final investor. However, this is not a rule. It often happens that the introduction of one additional link may potentially result in another taxation phase being related to the same profit. It is essential, therefore, to lower the effective total taxation. When deciding about an indirect investment, special attention must be paid to the location of a holding company, to avert a situation where the company generates nothing but additional costs (including tax burdens) for the shareholder, instead of tax benefits.

Thus, an investor must analyze each time whether it is more profitable to make a direct investment (purchase/acquisition of shares in an operating company) or to purchase the shares through a holding company (Lener, 2000, p. 30).

This analysis should be performed taking into account the basic types of income that may arise in connection with an investment:

a) active income generated from direct business activity in a given jurisdiction (conducted by a local operating company);

b) passive income, usually in the form of dividends from a purchased operating company; and

c) capital gains from the disposal of shares in an operating company.

Rules for taxing active income, i.e., income generated directly from business activity, are governed by a given jurisdiction's tax regulations.

Conversely, in the case of passive income, i.e. that from dividends, in most jurisdictions (*e.g.*, the Netherlands, Switzerland) the so-called classic tax system is used to tax the distribution of profit generated by legal persons. Tax is imposed on income generated by a company in the hands of that company and when it is distributed to shareholders as dividends, it is taxed again.

To avoid multiple taxation of the same profit in the form income tax, two methods are employed:

1) the exemption method, which allows exemption of the received dividends from tax in the hands of the recipient; and

2) the method of underlying tax credit, which provides that when a dividend is subject to repeated taxation, the recipient company may use the possibility of lowering the amount of tax payable by the amount of income tax paid by the distributing company, based on the share of the profit paid out in the form of a dividend.

Where the first method is adopted, no additional tax burden is imposed, other than the tax already paid by an operating company (and perhaps withholding tax imposed on dividends distributed by a holding company). The second method enables the achievement of the same effect only if the tax rate in the holding company's state is equal to or lower than the rate applicable in the state where the operating company is located. Otherwise, despite the possibility of reducing the tax payable in the holding company's state by the tax paid in the jurisdiction of the operating company, the difference in tax must be effectively supplemented (matched) in the holding company's state.

Considering the above in terms of optimizing the taxation of a dividend transfer, the most advantageous jurisdiction to locate a holding company is a country that uses the method of exempting income from dividends received. The method of the underlying tax credit may be ineffective if the tax rate in a state where the operating company is located is lower than the rate in the holding company's state (because the holding company would thus be forced to pay additional tax).

Often, the most advantageous solution is to locate a holding company in a jurisdiction that not only does not impose additional tax on dividends received from an operating company, but also imposes no tax on capital gains from the disposal of shares in an operating company. This system is referred to as participation exemption. It is employed in many European countries.

Participation exemption is concerned with income from dividends and capital gains generated in connection with shares held in so-called "qualified entities" (Schaffner,2006, p. 40). The definition of a qualified entity varies across jurisdictions, however, they are usually defined as the following types of entities:

- entities from certain jurisdictions (*e.g.*, from countries that have entered into an agreement on the avoidance of double taxation with the state of the holding company's residence);
- entities in which a holding company has at least a specified percentage of shares (*e.g.*, 20% in Switzerland, 10% in Luxembourg, 5% in the Netherlands, and 1% in Cyprus); and
- entities in which a holding company possesses shares for a specified period (*e.g.*, 1 year in Luxembourg and Switzerland).

Often, additional criteria must be met — for instance, an operating company should be subject to income tax in the state of its residence and the amount should be similar to the tax in the holding company's state. In some jurisdictions, shares in an operating company must be owned directly by the holding company for it to use the exemption.

Not all jurisdictions that use participation exemption and that possess a network of advantageous agreements on the avoidance of double taxation offer beneficial rules for taxing the dividends distributed from these states. Conversely, when selecting a jurisdiction in which a holding company is to be located, it is important for a payment from a holding company to the final investor to be subject to zero or minimum withholding tax in the state of the holding company's residence. To achieve the above-mentioned objective, another condition that a jurisdiction must satisfy to be an advantageous location for a holding company is a lack of withholding taxes on profits distributed as dividends (Peters, Snellaars, 2001, p. 43).

To recapitulate, a jurisdiction that is advantageous for a holding company from the point of view of capital gains tax is one where there are no (or low) taxes imposed in the following situations (Gajewski, 2017, p. 231):

a) in the case of payments made by subsidiaries to a holding company — there should be zero or a low withholding tax resulting from an agreement on the avoidance of double taxation or domestic regulations in the state of an operating company;

b) in the case of dividends received by a holding company from subsidiaries;

c) in the case of capital gains, where a holding company disposes of shares in subsidiaries;

d) in the case of profits distributed to shareholders by a holding company — there should be no or a low withholding tax; and

e) in the case of dividends ("sent" from a holding company) in the hands of shareholders — there should be advantageous taxation resulting from an AADT.

An alternative to participation exemption is a tax jurisdiction that does not exempt capital gains from tax, but that enables a company to classify a large group of costs related to generating capital income (such as acquisition costs, financing costs, etc.) as tax deductible. Some jurisdictions allow for the combination of all types of capital revenue and the resulting costs. Such a consolidation makes it possible to compensate for losses suffered from one investment with capital profit from another. From time to time, although rarely, capital losses may be used to lower a tax base assessed based on profit from operating activity (Meuseen Gerard, 1999, p. 67). Such a mechanism may operate where there are no specific, separate provisions governing taxation of capital gains, which in principle are taxed like operating income. In certain cases, such a seemingly disadvantageous system (in which capital income is subject to the same rules of taxation as operating income) may actually be very effective (*e.g.*, when capital losses may reduce income from operating activity subject to tax).

In principle, the acquisition of operating companies is connected to substantial expenses and, in practice, it is very often substantially financed by external loans (*e.g.*, bank loans, credits, or mezzanine financing).

The possibility of classifying income from interest on a loan taken for the purpose of acquiring shares as tax deductible by a holding company has sparked major controversy and may lead to ineffective taxation. Firstly, there is doubt as to whether the cost of interest satisfies the basic criterion for classifying an expense as deductible income, and thus whether it is related to taxable revenue. One may claim that the cost of financing share acquisition is incurred directly for the purpose of obtaining dividend from an operating company or to obtain profit from disposing of shares in an operating company. In such a case, if, in a given jurisdiction, dividends (or capital incomes) are exempt from tax, there is a risk that tax authorities will deny a holding company the right to recognize interest as deductible income. In such a jurisdiction, additional tax planning is inevitable.

Some tax systems require the recognition of costs incurred in connection with a share purchase to be deferred until the shares have been disposed of (i.e., capitalization of any costs to their value). Consequently, if the cost of interest on a loan taken for the purpose of purchasing shares is classified as an expense that has a direct connection to purchasing the shares, tax authorities may therefore deny a holding company the right to recognize this cost on the date it was incurred on. In such a case, a holding company would have the right to reduce a tax base by the cost of interest exclusively on the date it disposes of the shares purchased on credit (Orlov, 2005, p. 37).

From practical perspective, it should be observed that even if a holding company is entitled to recognize interest as tax deductible in such a jurisdiction, it will not usually earn the required revenue that could be lowered by the cost of financing. In most cases, a dividend received is the only (or main) source of a holding company's revenue, which in principle is not subject to taxation in the hands of the holding company.

On the other hand, it might be desirable for the cost of such financing (in a form of interest) to be able to effectively lower a tax base, for instance, by reducing (for tax purposes) operational profit earned by the purchased operating company. Taking the above into account, to fully benefit from the possibility of deducting interest, an investor should consider all of the available possibilities for shifting debt to an operating company that generates profit. The techniques leading to emergence of the desired structure are referred to as debt-push-down techniques.

A sample debt-push-down technique is a merger of a holding company (the financing company) with an acquired operating company. As a consequence of this merger, the interest on financing a loan taken for the purpose of purchasing an operating company (along with its assets) remains directly in one entity, along with the assets. As a result, arguments that interest is paid to obtain the revenue generated by the purchased assets seem more justified.

Another technique allowing for the recognition of interest as tax deductible is tax consolidation, i.e., the possibility of reducing the tax profits generated by some subsidiaries by the losses suffered by the other companies in the group (*e.g.*, the holding company). In such a case, interest will be deductible in the hands of the holding company. However, because the tax result of the holding company is consolidated with the result of the operating company, the tax base will be reduced.

To avoid abuse of the above-mentioned possibilities with respect to transactions between associated entities, some countries have introduced a variety of limitations on these techniques.

One must note that a jurisdiction's additional advantage is that it ensures the possibility of offsetting losses from "unsuccessful" investments in operating companies, *e.g.*, by making it possible to reduce a holding company's taxable income by a loss on a subsidiary's shares at its liquidation. In some cases, this solution may be more beneficial for an investor than the sole possibility to include neither profit nor and loss in a tax base.

A jurisdiction that is advantageous for a holding company, should also allow for quick "exit from a structure," especially by disposal of an operating company's shares, without incurring additional administrational costs, *e.g.*, in the form of so-called exit taxes.

In an attempt to ensure tax neutrality for profit transfers to investors, countries such as the Netherlands, Cyprus, and Malta have decided to introduce the above-discussed solutions (Chetcuti Dimech, 2006, 9). Because of their liberalized attitudes, those countries are widely recognized as regimes that are advantageous for international holding structures in terms of tax savings.

Nonetheless, at tax planning through the use of non-tax-haven jurisdictions that offer advantageous solutions for holding companies, it should be taken into account that such countries frequently protect their own fiscal interests by combining beneficial tax solutions with laws intended to fight tax evasion. Therefore, when choosing a jurisdiction for a holding company, it is important to not only consider the jurisdiction's positive aspects, but also its limitations in terms of the jurisdiction's own planning; this is necessary with respect to the jurisdictions of both the holding company and the subsidiaries.

Conclusion

Indubitably, a holding company is a solution conducive to tax saving processes. The effectiveness of this solution depends on many factors. However, the key aspect is the specific nature of the jurisdiction in which the construction of a holding company is used.

To recapitulate, an ideal jurisdiction for a holding company should meet the following minimum conditions:

1) it should offer tax benefits with respect to dividends received by a holding company, which requires that dividends received by a holding company from a subsidiary must either be exempt from withholding tax in the state of a subsidiary's residence, or be subject to minimum withholding tax;

2) it should offer tax benefits related to received dividends in the holding company's state of residence, and those tax benefits should either exempt from tax a holding company's income from dividends received from subsidiaries, or make this tax minimal;

3) it should offer tax benefits with respect to taxation of income generated from the disposal of shares, and those tax benefits should either exempt from tax a holding company's income from the disposal of shares in a subsidiary, or make this tax minimal;

4) it should offer tax benefits with respect to distributed dividends, and those tax benefits should either exempt from tax the dividends paid by a holding company to an ultimate company, or make this tax minimal;

5) it should have an extensive network of treaties related to the avoidance of double taxation, which would allow a holding company to use treaty protection with respect to the received dividends;

6) it should offer a holding company the possibility to offset losses on investments in subsidiaries (*e.g.*, at their liquidation);

7) it should offer the possibility of deducting expenses related to financing the acquisition of a subsidiary;

8) it should not impose tax on capital at the time of the establishment or increase of a holding company's capital;

9) it should not limit planning (*e.g.*, regulations regarding circumvention of the law, CFC rules, or rules on thin capitalization) or those limits should be relatively mild, thus decreasing the possibility of financing a holding company with loans from shareholders; and

10) it should have a stable tax statute and offer the possibility of obtaining a binding interpretation that would ensure a stable tax situation for a holding company.

In summary, a holding company is an important element in tax planning. Because of those companies' tax privileges, they are the perfect tools for shaping transactions intended to minimize tax burdens. An essential element in devising tax structures is the holding company's location. Selection of the most beneficial of the existing tax jurisdictions is the only way to ensure achievement of company objectives regarding expected tax savings.

The above analysis has been concerned with the rules for operating and taxing holding companies that may be established in EU Member States. It enables the conclusion that tax havens are not the only countries that may offer preferential conditions for establishing, running, and taxing companies. Because of the existence of holding companies, EU Member States are also attractive tax jurisdictions for investors in search of legal tax savings. Nonetheless, to create a structure that is effective in terms of tax optimization by using holding companies, it is not only necessary to possess knowledge of the rules concerning their establishment and taxation in the state of tax residence, but also to search for attractive solutions provided in AADTs. In many cases, an effective international optimization structure will consist of holding companies established in one of the EU Member States and companies situated in countries considered to be tax havens.

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