Published on *The National Law Review* https://natlawreview.com

Brexit Update: UK as a Holding Company Hub

Article By:

Nicholas Azis

The United Kingdom is still an attractive location for a holding company, despite the uncertainty over Brexit.

In Depth

Recent reports in the British media of international groups transferring all or part of their operations to a UK holding company structure, or re-domiciling to the United Kingdom, at first appear counterintuitive in the context of current uncertainty generated by the United Kingdom leaving the European Union.

The activity is, however, a natural consequence of a combination of factors.

- An active UK government tax policy over the last 10 years designed to create a more favourable environment for international business relocating to or setting up in the United Kingdom.
- The repercussions of the European Commission's increasing willingness to take action on grounds of unlawful State aid against EU Member States that grant international companies special tax advantages as an enticement to re-domicile.
- National governments themselves challenging companies that have tax strategies designed to shift profits to low or no-tax locations in response to the Organisation for Economic Co-operation and Development's base erosion and profit shifting project (BEPS).
- The desirability of the United Kingdom as a location from business and employment perspectives.

Evolving UK Tax Policy

There was some scepticism around the United Kingdom really being "open for business" in the early 2000s, as some of its largest companies with significant foreign earnings—WPP plc, Wolesley plc, UBM plc, Informa plc and Shire Pharmaceuticals plc, amongst others—moved their corporate domicile out of the United Kingdom to countries such as Ireland and Switzerland. They were protesting against the increasing effects of the continued imposition of the full rate of UK corporation tax on foreign earnings distributed to the UK parent (subject to a credit for foreign tax), and against the broad scope of the controlled foreign company (CFC) rules. In certain circumstances these can impose immediate UK tax on undistributed low-taxed foreign earnings.

To stem the flow of corporate re-domiciles abroad, and in an attempt to change negative perception, in 2009, the UK Labour government introduced an exemption for most foreign dividends received by UK companies. The subsequent coalition government built on this by overhauling the CFC rules to ensure they were targeted at structures that artificially diverted profits away from the United Kingdom. These changes have led to some of the companies mentioned above re-domiciling back to the United Kingdom.

In line with this change in policy, the UK government has also steadily implemented other measures designed to make the United Kingdom more attractive.

- The rate of corporation tax in the United Kingdom has progressively been reduced from 30 per cent in 2007 to its current level of 20 per cent, and is scheduled to reduce further to 17 per cent by 2020. This also reduces the effect of the CFC rules that only apply to foreign income taxed at a lower rate relative to the United Kingdom.

- The “patent box” regime, which allows companies to elect for a 10 per cent effective rate of corporation tax to apply to profits deriving from patents, was designed to attract and encourage high technology and life science companies to the United Kingdom.

- The simplification of the substantial shareholding exemption, which provides a tax exemption for capital gains arising on the disposal of trading companies in which the taxpayer holds a 10 per cent or greater shareholding. This was designed both to reduce tax considerations unduly influencing business decisions on restructuring and reinvestment, and to dis-incentivise corporates adopting complex off-shore holding structures to avoid capital gains tax.

These changes build upon the established benefits of the UK tax system, such as the absence of any withholding tax on dividends paid by UK companies and one of the widest networks of tax treaties, which can be used to mitigate other withholding taxes on payments to and from UK companies.

European Commission Action

The European Union has estimated that US$1.3 trillion is lost each year in the Union by tax avoidance and evasion. It has taken a number of measures to ensure that the tax planning undertaken by multinational corporates is more transparent. From 1 January 2017, tax authorities within EU Member States are required to exchange cross-border tax rulings and pricing agreements granted to taxpayers by other EU Member States’ tax authorities on an automatic basis. The European Union is also considering whether or not to require the publication of country-by-country reports that large corporates are now required to prepare pursuant to BEPS.

In terms of substantive law, the European Union has amended the Parent-Subsidiary Directive to require Member States to tax dividends that give rise to a deduction for the paying party, which the UK Labour government’s 2009 reforms implemented. Following the completion of the BEPS project, the European Union is implementing many of its conclusions, not least through the Anti-Tax

Avoidance Directive, which requires the corporate tax systems of Member States to have limits on interest deductions, limited hybrid mismatch rules, a general anti-avoidance rule and CFC rules. The directive will come into force at the beginning of 2019 and will act as minimum standards. Member States can impose tighter restrictions than required if they wish.

As the United Kingdom is expected to be leaving the European Union in or shortly after 2019, the new directive is unlikely to apply to it for any length of time. This, however, may make relatively little difference: the UK tax system as it stands already contains most of these provisions, and reforms to be made during 2017 are likely to bring in the remaining ones.

Post-BEPS World

Countries have reacted to the BEPS project in different ways. Some initiatives, notably country-by-country reporting, have been widely embraced; whilst others, such as the hybrid mismatch, CFC and tax treaty proposals, have received a more mixed reaction. Some countries have gone their own way, most notably the United Kingdom with the introduction of the Diverted Profits Tax from 1 April 2015. Some clear, common themes are, however, starting to emerge.

Tax authorities, for example, are increasingly applying the arm's length standard for transfer pricing purposes by reference to "substance", by which they generally mean employees and the performance of substantive activities. It is therefore likely to become increasingly difficult for corporates to defend substantial royalty payments to intellectual property (IP) holding companies in low tax or haven jurisdictions that do not have the operational substance to manage and exploit that IP themselves. Furthermore, the requirement to file country-by-country reports will mean that arrangements of this type will be very obvious to tax authorities, meaning they may well be challenged more frequently.

UK as Jurisdiction of Choice

The United Kingdom has long been regarded as an attractive location owing to its convenient time zone, which enables business to be transacted during the working day in Asia, Europe and the United States, and its position as a hub for financial and other service industries.

It also offers a pool of available management and is an attractive location to hire in and retain managers and employees from outside the United Kingdom. From the point of view of those employees, the United Kingdom has well-established, transparent and flexible labour laws.

Conclusion

As a means of justifying "substance" which, as we have seen, in a post-BEPS world is becoming increasingly important for companies in managing their tax affairs, the establishment of a holding company structure in the United Kingdom, where there may well already be a significant corporate presence, aligns corporate structure with management and operations.

This also provides a sound basis to argue before a tax authority that royalty payments are justified, since the underlying intellectual property is being genuinely exploited by management operations in a non-tax haven jurisdiction.

National Law Review, Volume VII, Number 32