CASE STUDY: TAX EFFICIENCY OF A HOLDING COMPANY

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ABSTRACT

The Chief Executive Officer of a multinational Group is concerned about his Board's decision to decrease significantly the tax cost by about 40 % over the next two years based on the latest audited Financial Statements to boost the profits and gain a competitive advantage for a Holding Company in the current turbulent economic environment.

The CFO is working on the Group's holding structure, intra-group financing arrangements and service fees, in order to satisfy the Board's requirement i.e. to cut the tax bill by about 40 %, resulting in boosting the profits by the same percentage, everything being equal.

The CFO highlights potential tax weaknesses and assess the tax efficiency of the current holding structure of the Group as well as the Group's financing arrangements; He identifies the limitations of the current service fee arrangement from a corporate tax and transfer pricing policy and documentation perspectives, as well as the factors that need to be considered when determining arm's length price for intra-group services.

Keywords: corporate tax, holding structure, multinational Group

BACKGROUND

On March 22, 2019, the CFO was preparing for a meeting with the Board of Directors of the Holding Company the next morning.

The CFO swiveled his chair to look at the view from his office at Group headquarters. He had just received a call from his CEO. The latter had told him that the Directors of the Board would like to meet with them. The topic of concern was the significant tax cost that the Group is incurring on yearly basis.

The Directors wished to discuss some questions related to that area of concern that was significantly affecting the Group's bottom line. The Group had grown rapidly thanks of the CEO and his team's entrepreneurial and managing skills. The revenue of 2018 was higher than the revenue of 2017 by 30 % and the revenue of 2016 by 40 %.

These increases in the revenues led to an increase the tax cost by 50 % over the last two years.

The Board of Directors found this tax cost as colossal and decided it wanted to hear the CFO's views on how to plummet it especially that the CEO had budgeted a revenue increase of 40 % for 2019, resulting in an increase of the budgeted tax cost by about 20 %.

THE PROBLEM

Can the CFO decrease the tax cost in 2019 and 2020 by about 40% to boost the consolidated profit of the Group and therefore improve more the rating of the Group before its Bankers and investment community as well as gain a competitive advantage?

The Directors greeted the CEO and the CFO as they entered the Board room. "Gents, we have a challenge that we hope you can help us with. We need additional profits, everything being equal, by cutting our tax cost."

The CFO realized that this would require some creativity and he began to brainstorm.

A number of ideas ran through his mind, some of them reasonable, other a bit compromising.

The CFO answered, "well, we would have some options."

1. We should review thoroughly the Group's holding structure and assess its tax efficiency and all of its significant jurisdictions.
2. We should analyze the Group's financing arrangements and assessing the tax efficiency of the external debt facilities of the Holding Companies (Luxembourg and Tax Haven) and intra-group debt funding of the Group's significant jurisdictions.
3. We should explore tax issues related to the current service fee arrangement (intra-group arrangements) from a corporate tax and transfer pricing policy and documentation perspectives, as well as to the factors that need to be considered when determining arm's length price for intra-group services.

THE OPTIONS

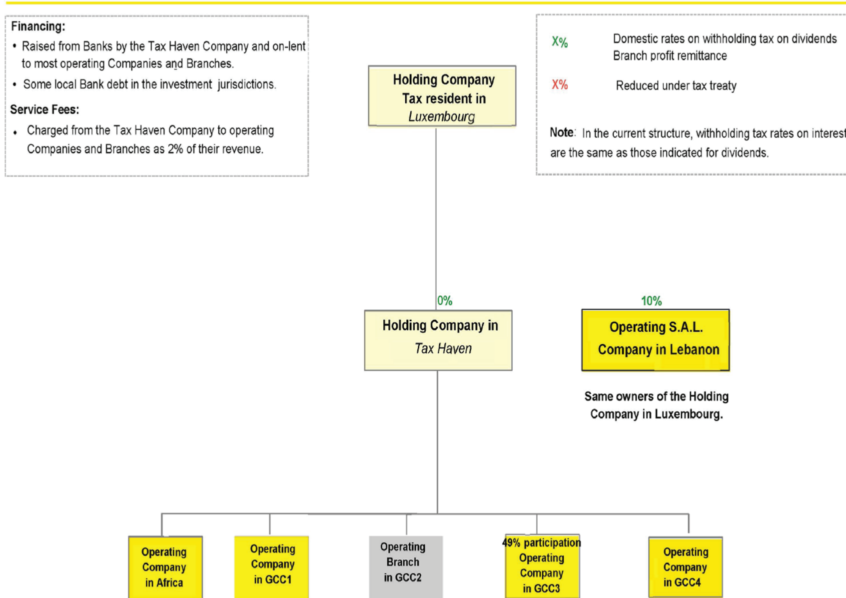
Option 1 Analysis of the holding structure

The current Group structure

The top Holding Company of the Group is tax resident in Luxembourg and ultimately holds the following investments:

- Participations in operating Companies in the GCC, Mena region and Africa; and;
- Operating Branches in the GCC.

The corporate structure of the Group, as it stands **currently,** is illustrated below:



The CFO assured the members of the Board of Directors that the current holding structure is generally efficient from a tax perspective because profits are upstreamed to the Holding Company in Luxembourg without incurring withholding tax leakages.

However, he indicated that he Group is incurring currently a 10 % and 5 % withholding tax cost on dividends in Africa and GCC1 respectively, but he added that he believes that he can engineer a withholding tax reduction from 10 % to 7.5 % in Africa and from 10 % to 5 % in Lebanon.

How to cut the 2.5 % and 5 % tax costs in Africa and Lebanon respectively?

The CFO made a recommendation to the Board of Directors to establish a Dutch **or UK** Holding Company and transfer the African shares from the Tax Haven Holding Company to the Dutch Holding Company and to establish a Cypriot Holding Company to become the Parent Company of the Lebanese operating S.A.L. Company.

According to the projection made by the CFO, this 2.5 % tax reduction will result in a $ 2 million tax savings.

He added that the structure is efficient because many investment jurisdictions (e.g. GCC2, GCC3, GCC4) do not levy dividend withholding taxes under current domestic legislation. However, he reminded them that tax treaties allow "locking in" reduced tax rates to protect against a change in domestic rules. This opportunity is not fully utilized, as most participations are held from the Tax Haven Company, which does not have an extensive tax treaty network.

The CFO continued and raised the 49 % participation issue in the GCC3 Company. He reminded the Directors of their decision taken previously to sell this 49 % participation for strategic purposes.

"So what idea do you have?" the CEO asked.

The CFO shook his head and without immersing the members of the Board and the CEO in many of the financial details surrounding the future exit strategy from the GCC3, simply put he stressed on establishing a Cypriot Holding Company (or a Dutch / UK Holding Company) to which the shares held (49 %) in the GCC3 Company will be transferred.

By doing so, the 15 % GCC3 tax on the gains on the shares may be eliminated, resulting in a $ 6 million tax savings (the estimated gain on the GCC3 shares amounts to $ 40 million).

Finally, in respect of the holding structure, the CFO highlighted two strategic issues related to tax efficiency.

1. The Tax Haven structure may be unsustainable in the long term and for a potential expansion into new markets knowing that the use of low-tax jurisdictions (such as Tax Haven) is increasingly scrutinized by the tax authorities in investment jurisdictions.
2. Currently, most investments of the Group are structured as Branches, rather than subsidiaries-this is generally tax efficient for profit repatriation, but complicates a future exit from individual jurisdictions (given licenses, permits, track record, etc. may not be separately transferable).

Therefore, the CFO recommended that the Directors consider investing through local subsidiaries rather than branches for their future new investments.

Option 2 Analysis of the intra-group financing arrangements

“ You have a variety of alternative courses of action to recommend in order to reduce the Group’s tax liability significantly. What else is there?” The CEO asked.

The CFO steepled his fingers and looked at his CEO. “True.”
In respect of the intra-group financing arrangements, the CFO made it clear that this approach generally appears tax-efficient, particularly because:

1. Financing operating Companies in high-tax investment jurisdictions with interest-bearing debt generates interest expenses deductible for tax purposes (subject to conditions);
2. Interest margin booked by a Tax Haven Holding Company should be taxable at 0 % corporate income tax (CIT); and
3. No withholding tax should arise in respect of interest payments from a Tax Haven Holding Company to lenders, irrespective of their tax residence.

However, he indicated to the Board’s members and the CEO that the interest in intra-group debt is currently subject to withholding taxes in Africa (10%), GCC1 (5%) and Lebanon (10 % - it would be treated same as dividends because the financing comes from the Parent Company). These tax leakages may be mitigated through the use of tax treaties.

Africa: Withholding tax on interest may be reduced from 10 % to 7.5 % if intra-group debt is provided from a Dutch / UK Company instead of a Tax Haven Company.

GCC1: Withholding tax on interest may be reduced from 5 % to 0 % if intra-group debt is provided from a UK Company instead of a Tax Haven Company.

Lebanon: Withholding tax on interest may be reduced from 10 % to 0 % if intra-group debt is provided from a UAE Company instead of a Tax Haven Company.

The above withholding tax rates reductions will result in a $ 3.5 million tax savings according to the CFO.

To conclude on this second option, the CFO highlighted a high risk that interest expenses may be challenged by the tax authorities, as being non-arm’s length (i.e. not on market terms) because of the lack of formal transfer pricing methodology or documentation.

Therefore, in order to support the Group’s interest expenses and avoid any challenge carried out by the tax authorities, the CFO recommended that the Group develops a transfer pricing methodology for intra-group debt and prepares transfer pricing documentation where required.

The CEO enquired how to maximize the Group’s tax-deductible interest.

The CFO responded. "The Group may not be fully utilizing the opportunity to reduce its overall effective tax rate by maximizing tax-deductible interest expenses. Debt capacity analysis may be carried out as part of transfer pricing work to determine how much additional debt may be provided to each operating Company within the arm's length range."

Option 3 Tax issues related to the intra-group service fees

After a three hour meeting, the CEO grinned. "What else?"
The CFO replied that there is still a third and last course of action to explore that is specific tax issues related to the intra-group service fees.

Currently, the service fees are charged from the Tax Haven Company to the operating Companies at 2 % of their revenues.

The CFO recommended that the direct charge be made via an Offshore Company to be established in Lebanon because fees charged from the Tax Haven Company (a low-tax jurisdiction) may receive additional scrutiny from the tax authorities in the investment jurisdictions (Africa, GCC1, etc.).

He reiterated that there is a high risk that service charges may be challenged by the tax authorities as being non-arm's length (i.e. not on market terms) because there is a lack of a formal transfer pricing methodology or documentation to support the service charges / headquarters cost allocations.

The good news was at the end of the meeting when the CFO recommended to increase the service fees from 2 % to 4 % that according to him will result in a $ 3 million tax savings because of the increase in the service fee cost (tax deductible).

THE DECISION

The CEO and CFO are confronted with a number of intertwined tax, legal and cost issues.

The CEO's ultimate responsibility is to ensure that the future tax liability will be reduced significantly, resulting in an increase of the Group's profits (everything being equal) and gaining a competitive advantage.

It is important to bear in mind that, if the Group wishes to rely on treaty benefits (such as reduced withholding tax rates), it would need to create sufficient economic substance at the selected Holding / Financial Companies' jurisdictions.

In the current international tax environment, reliance on "letterbox" Companies lacking any commercial substance (management or operations) in their home jurisdictions does not appear sustainable. This is particularly the case in view of the Organization for Economic Co-operation and Development's (OECD) release of the Base Erosion and Profit Shifting (BEPS) project reports, which aim to prevent improper use of tax treaties.

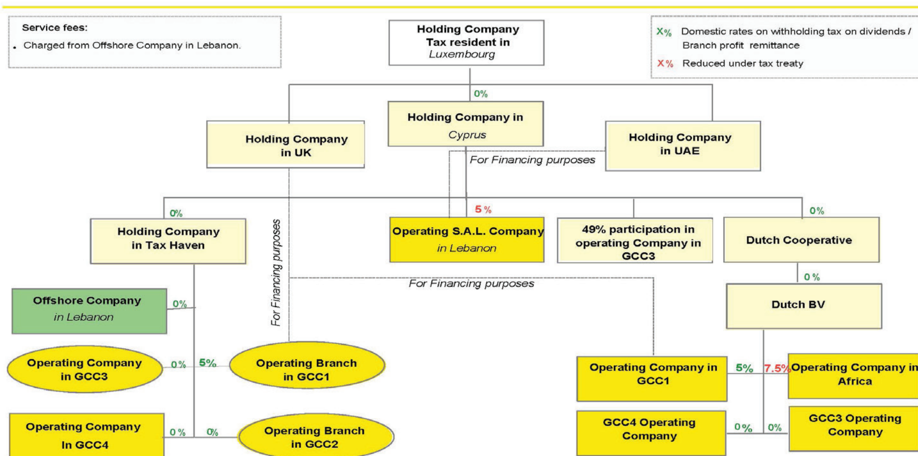
Given creating economic substance in Holding and Financing jurisdictions may be costly, the CEO and CFO would ultimately need to decide on the desired structure on the basis of cost/benefit considerations, as well as their attitude to risk.

They should also be conscious of the tax authorities' increased focus on pricing of intra-group transactions. The Group's intra-group financing and service fee arrangements should be managed to ensure that the pricing is on market terms and supported by transfer pricing documentation.

The Directors place their trust in the CEO and CFO to make decisions that are in the Group's best interests.

In view of the nature of the Group's transactions as well as their huge amounts involved, tax and non-tax considerations and after assessing the opportunities presented by the CFO as well as the benefits justifying the cost of creating new Holding Companies (including maintaining sufficient substance in the Netherlands and the UK), the CFO has proposed the following new structure and also highlighted its advantages over the current one.

Proposed Group Holding Structure



ADVANTAGES

Dutch Holding Company	UK Holding Company	Cypriot Holding Company

Common advantages over the current structure:

- *African withholding tax on dividends and interest may be reduced from 10 % to 7.5 %.*
- *Capital gains on the 49 % participation in the GCC 3 Company may be protected against GCC 3 tax on disposal (15 %)*
- *Generally regarded as more reputable jurisdictions than Tax Haven*
- *Wider tax treaty networks, i.e. provide a more suitable platform for future expansion*

Relative advantages:

Dutch Holding Company	***UK Holding Company***	***Cypriot Holding Company***	***UAE Holding Company***
• *New investments into GCC1 (structured as subsidiaries) may be protected against GCC1 Tax on capital gains upon eventual disposal (20 %).*	• *GCC1 withholding tax on interest may be reduced from 5 % to 0 % under the UK-GCC1 tax treaty.*	• *Because a UK Holding Company is less suitable for raising loans (20 % withholding tax on interest, reduced for certain lender jurisdictions), a Cypriot Holding Company may be used to reduce the withholding tax rates.*	• *Lebanese withholding tax on interest may be reduced from 10 % to 0 % if intra-group debt is provided from a UAE Holding Company.*
• *Dutch Holding Company suitable for raising loans (no withholding tax on interest in the Netherlands).*		• *Lebanese withholding tax on dividends may be reduced from 10 % to 5 % under tax treaty.*	

In making a "reasonable" decision to re-structure the Group as proposed by the CFO, the Board of Directors would meet their objective to plummet the tax cost, resulting in increasing significantly the bottom line of the Group by 40 % (everything being equal) and gaining a competitive advantage.