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inBrief

Canada edition

Cross-Border Holding Companies: The New Normal

By James Bowden | 26 January 2023

Holding companies are an important part of almost any deliberately planned corporate structure. By "holding company" we are referring to a legal entity whose primary, or possibly sole, function is to own other assets. They are important for asset protection, segregating lines of business or assets, limiting liability, tax planning and estate planning, among other things. This inBrief discusses the continued utility of holding companies against the backdrop of a heightened regulatory focus in recent years.

For those operating in higher tax jurisdictions like Canada, the United States, the UK and the EU, establishing holding companies in tax-preferential jurisdictions has been a popular strategy, as there were legitimate tax advantages available by doing so. Those tax advantages would have generally involved either accessing a benefit (reduced rates) under a tax treaty, or deferring the tax on income accumulated in the holding company.[1] There is a misconception that holding companies operate to conceal ownership or tax information from tax or law enforcement authorities or that they otherwise facilitate illegal activity, or that a taxpayer can simply decline to disclose foreign assets or holdings thereby shielding them from tax. While that may once have been true (perhaps before the internet era), it is not true now and has not been for many years.

There has also been a perception that holding companies have facilitated a practice known as profit-shifting: the practice of deliberately shifting revenue from being earned in a high tax jurisdiction where the substantial business actually takes place, to a company established in a low/no-tax jurisdiction where the business has little or no substantial economic activity. This was indeed a common and lawful practice and was usually not considered to be abusive.[2] Over the last seven to eight years, such arrangements have been recharacterized as abusive as a result of OECD initiatives in that regard, most notably what is known as the **BEPS** project (which stands for base erosion

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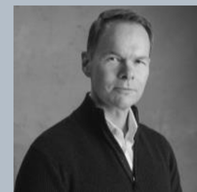

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[1] The deferral advantages have not been available for several years in most jurisdictions due to comprehensive domestic legislation in every high-tax country, and the treaty advantages are quickly disappearing as a result of the BEPS initiative (discussed below).

[2] It was generally not an abusive practice because such practices were already very heavily monitored and regulated by domestic tax legislation which applies to interests in foreign entities, transfer pricing, thin capitalization, along with many anti-avoidance and attribution rules.

and profit shifting). The BEPS project is an OECD initiative that is aimed at promoting policy and legislative changes globally that are designed to increase tax revenues for OECD nations by combatting what they characterise as abusive practices.[3] The use of holding companies has been a major focus of the BEPS initiative and the holding company landscape has radically changed as a result.

The arrival of "economic substance" requirements in low/no-tax jurisdictions is perhaps the most important change, as such requirements have made prior profit-shifting practices difficult or infeasible. One of the action items under the BEPS project (Action 5)[4] is to deal with what the OECD has identified as "harmful tax practices", which includes profit-shifting to low/no-tax jurisdictions. To prevent profit-shifting, low/no-tax jurisdictions were required to implement "economic substance" rules, which operate essentially as follows: if a company is foreign-owned and carries on activities that are typically associated with passive income (such as holding investments or IP, or acting as a regional headquarters, or offering passive financing, among other things), then such companies must demonstrate that they have adequate economic substance in the country of incorporation, failing which they will be fined and ultimately shut down. Adequate economic substance is demonstrated by having physical premises in the country, local full-time employees, local assets, local expenditures, a local bank account, and physically present local board and management activity.[5] Put another way, if the entity meets the economic substance test, it is no longer really a holding company in the traditional sense, it is simply an active company.

For an entity that solely carries on "holding" activities as narrowly defined in economic substance legislation and has no other function (acting as a region headquarters or owner of group intellectual property, for example), the level of economic substance required is significantly reduced. The economic substance rules (including the lesser requirements for pure holding entities) adopted into law are generally consistent across all conventionally popular low/no-tax jurisdictions, as they follow OECD guidance.[6]

The general expectation several years ago was that the BEPS initiatives would cause companies to move their assets and operations back to the higher tax jurisdictions in which the parent company or group was physically based, rather than seeking out the most tax-efficient location. Instead, the more common reaction was for companies to develop the required economic substance (genuine active business, full time employees, physical offices, etc.) in the low/no-tax jurisdictions, in order to continue to legitimately benefit from preferential tax regimes. The landscape has changed so that companies in tax-preferential jurisdictions are only useful if they actually carry on an active business and meet the economic substance requirements, or, in the case of pure "holding" companies as defined in the legislation, they meet the reduced economic substance requirements. These developments have made offshoring more expensive than it used to be, but it is clearly still a worthwhile proposition for many businesses for which at least some of their active business can be conducted in preferential jurisdictions.

Another area in which holding companies have been affected by the BEPS initiative is with respect to eligibility for tax treaty benefits. Access to treaty benefits has been limited for holding companies, pursuant to BEPS Action 6 (Prevention of Tax Treaty Abuse). Previously, a holding company established in a country with which Canada[7] has a tax treaty was treated as a resident of the treaty country and was therefore entitled to the treaty benefits. That typically means that payments to the holding company from Canadian entities or sources were subject to reduced withholding tax rates, and capital gains in the holding company

[3] More information about BEPS can be found here: https://www.oecd.org/tax/beps/about/#mission-impact

[4] The BEPS project consists of 15 separate "Actions", each focussed on a particular issue or category of issues.

[5] A physically present board is no longer achieved with a "fly in, meet, fly out" approach, as was the case (and continues to be) for purposes of the company's "residency". A company may be tax resident in the country of incorporation but still not meet the economic substance tests.

[6] We note that some low/no-tax jurisdictions have not yet adopted economic substance legislation, such as Nevis or the Cook Islands, although most have.

[7] We are using Canada as an example, although the concept is applicable to many other countries.

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could often be realised entirely tax free. It became popular to establish holding companies in treaty countries specifically to access the treaty benefits for a particular transaction or category of transaction and for no other reason; a practice viewed by the Canadian courts, incidentally, as consistent with the purpose of the treaties, and not abusive.[8] As was the case with profit-shifting, the use of a mere holding entity without adequate economic substance whose purpose was primarily to access a tax benefit was recharacterised as abusive pursuant to BEPS Action 6. The OECD addressed this form of "abuse" by introducing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the **MLI**), which has one primary effect: to amend existing tax treaties to deny the application of benefits under the treaties if "one of the principal purposes" of any arrangement was to access the treaty benefits.[9] The MLI is controversial as there is significant uncertainty around how the "principal purpose test" will be applied in practice. Pending further clarity on this, the availability of treaty benefits will be uncertain in almost any circumstances, and any planning that relies on treaty benefits will be riskier. For further discussion of the potential conflicts and uncertainty caused by the MLI in Canada, please see our earlier inBrief here: Tax Minimization is Every Canadian's Right: Supreme Court of Canada.

To recap, holding companies have been the focus of global tax reforms, resulting in the advent of economic substance requirements in low/no-tax jurisdictions, and the introduction of the MLI which is aimed at preventing "treaty shopping". Today, as a result, foreign-owned companies established in low/no-tax jurisdictions are only beneficial from a tax perspective if they can demonstrate the required economic substance through people, premises, assets, and expenditures. Passive holding companies with no local presence in such jurisdictions are no longer viable, and while it is open to debate, it is generally acknowledged that this is a positive step towards global tax fairness.

There remain many situations in which a holding entity is necessary as part of a corporate or family wealth structure where no tax advantage is being sought or realised, and as such, they should arguably not be subject to the same economic substance requirements as holding companies which do result in tax advantages. For example, it is often advisable for a family trust to establish one or more holding companies that are owned by the trust and which are useful for legitimate asset protection, segregation and management. Such holding entities also enable the adoption of bespoke family governance mechanisms at the holding company level through the use of shareholders' agreements, board structures, and a family charter, for instance. If the trust has been established in a tax-effective manner (e.g., if the trust assets originated from persons resident in a tax-preferential jurisdiction, and depending on the domestic tax treatment of its beneficiaries), the purpose of the holding company would likely not be tax-driven beyond simply a wish to avoid making the position worse. However, in the current landscape, the addition of a holding company under the trust can have negative consequences, even though such consequences do not arise for the trust itself. These sorts of holding companies have been caught in the crossfire, so to speak. Where the trust has EU or US beneficiaries, for example, the mere introduction of a holding company may trigger punitive sets of rules known as "controlled foreign affiliate" (or CFC) rules, where such rules would not have otherwise applied if the trust held the assets directly, even though the use of a holding company provides no tax advantage to the trust.[10]

A potential solution in the above example of a trust that requires a holding vehicle for non-tax reasons is the use of tax-transparent "flow through" entities, such as limited partnerships and certain limited liability companies. Such entities are typically established in high-tax jurisdictions like Canada and the United States, where economic substance rules have not been adopted. Generally speaking, such entities allow for

[8] See *Canada v. Alta Energy Luxembourg S.A.R.L, 2021 SCC 49*.

[9] The list of signatories to the MLI can be found here: https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf

[10] This is a general statement meant to illustrate the problem. The rules are complex and there can be exceptions if there is adequate opportunity to plan at the outset, and each set of facts should be reviewed on their own merits.

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a tax-neutral result while interposing a layer of segregation, management and control, and a limitation of liability, and can therefore often present an effective alternative to conventional offshore holding vehicles.[11]

Cross-border tax planning has always been complex, and the rapidly changing environment has only made it more so. It is essential to obtain fact-specific professional advice before implementing any such planning. Please contact us if you wish to explore whether international planning for yourself, your business, or your estate can be beneficial for you. ■

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[11] As noted, each specific set of facts should be reviewed on its own merits, and professional advice is essential in such planning.

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