Sustainability of upper tier structures – impact of BEPS

Highlights

- Sustainability of existing upper tier structures should be assessed in the light of the changing tax environment.
- If an upper tier structure is unsustainable, a buyer should consider acquiring at OpCo level.
- New structures should be driven by economic considerations to minimise tax risks.
- Hybrid financing is now under pressure; controlled foreign company (CFC) rules will likely be strengthened.

Is your upper tier structure BEPS proof?

Executive summary

The OECD BEPS Action Plan (for more details: see our previous release "Impact of BEPS on M&A: Why should we care?") and related EU and domestic developments impact each layer of a multinational group structure, including the upper tier.

To minimise the risk that a successful challenge by the tax authorities reduces the return on investment due to withholding tax exemptions or reductions being ignored, sufficient relevant economic substance should be present at each level of the upper tier structure. In addition, there need to be enough functions and economic risk at upper tier level to make sure that entities qualify as 'beneficial owners' of payments. Both items require thorough analysis and day-to-day monitoring.

The same reasoning goes for principal, R&D or financing models: the absence of relevant people, risks or functions at headquarter or financing centre level could result in taxable profits being reallocated to operational/borrowing entities, which are often subject to higher (effective) tax rates.

Hybrid financing is being challenged by both the OECD and the EU and might lead to unsustainable tax planning and/or an unsustainable effective tax rate (ETR). Even without tax benefits, hybrid financing could still be attractive from a financial point of view.

It's expected that some countries will introduce new – or strengthen their existing – Controlled Foreign Company (CFC) rules. These rules play an important role in the selection of a location for a holding or BidCo.

If you wish to have a helicopter view on acquisition structuring, please refer to the case study.

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1. Substance/beneficial ownership

Insufficient substance in your upper tier structure can lead to significant tax leakage!

The trend was already there and it has been reinforced by BEPS

Tax authorities around the world are increasingly challenging upper tier structures which are not supported by sufficient economic substance. To do so, they generally use existing anti-abuse measures, which they interpret increasingly broadly.

A successful challenge can have a significant impact on your return on investment

If your upper tier structure does not qualify as tax resident in the country where it is established, or if it is not the 'beneficial owner' of interest or dividend income, withholding tax exemptions will not apply, leading to withholding tax being due. On Belgian investments, this would mean a 25% tax leakage!

Sufficient substance at the level of intermediary holding companies is key ...

There must be sufficient economic substance at the level of the intermediary holding companies to make sure they qualify as local tax residents.

This should be taken into account at all levels of management: senior, day-to-day and administrative. But how?

- **Senior management:** hold board meetings and prepare information packages in countries where HoldCos are located; well-qualified directors should take active roles in the decision-making process ('no rubber stamping'); there should be a sufficient number of directors resident in the country where the company is located; etc.
- **Day-to-day management:** employee(s) with relevant skills should see to local daily activities (e.g. financing); solid and regular reporting should be in place; local bank accounts should be available; etc.
- **Administrative management:** availability of proper offices and equipment, local preparation and review of books and legal documents should be prepared and reviewed locally; compliance with local GAAP and other regulations; etc.

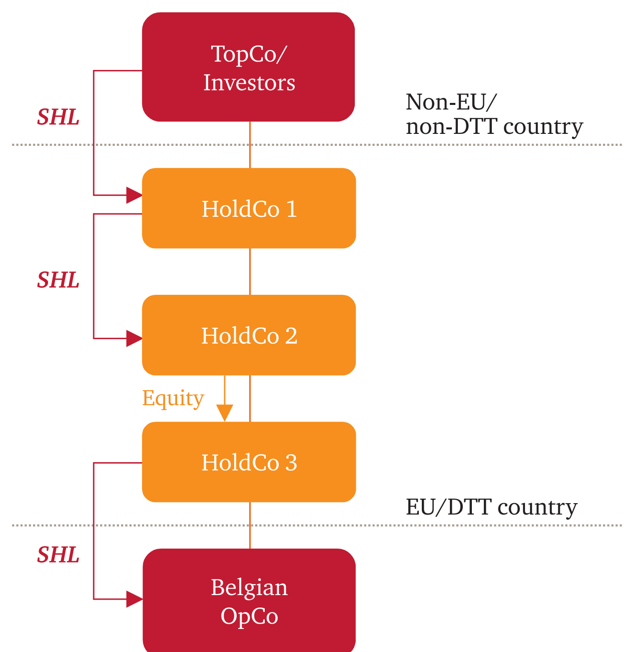
Conclusion: substance is highly fact based. Thorough substance reviews, defence files and day-to-day monitoring are crucial.

... as is beneficial ownership of received payments.

To be entitled to a withholding tax exemption in line with European Directives or a treaty benefit, entities receiving the dividend, interest or royalty payment must qualify as the 'beneficial owner' of the payment. While the Belgian courts used to interpret this in a legalistic way, we see tax authorities moving toward a more economic approach.

In multi-layer structures, it's important that the holding structure is supported by business reasons, has an active function and is subject to economic risk.

Sustainability of upper tier structures – impact of BEPS



In relation to the structure shown, for instance, the following would be important:

- Financing by HoldCo 2 to HoldCo 3 (and preferably also by HoldCo 1 to HoldCo 2) should have full equity characteristics (no pure back-to-back lending).
- The equity contribution to finance the loan to Belgian OpCo shouldn't constitute a separate class of shares.
- Day-to-day management of holding companies should be done locally ('substance').
- Documentation of the HoldCo 3-Belgian OpCo loan agreement shouldn't include any link to the loan financing granted to HoldCo 2/HoldCo 1.
- HoldCo 1 should bear full responsibility with regard to the receivable on Belgian OpCo, effective payments should be made by Belgian OpCo to HoldCo 3 and there should be no link to repayment obligations of HoldCo 2/HoldCo 3.

How can you deal with this in an M&A environment?

Recent developments in terms of substance and beneficial ownership have changed the way tax authorities look at upper tier structures. To reduce potential related risks, you're advised to:

- review (and if necessary adapt) existing structures to safeguard sustainability going forward;
- make substance and beneficial ownership a high priority in the due diligence phase of the acquisition process. If risks exist at upper tier level, a buyer could consider acquiring at OpCo level;
- make sure that new acquisition structures are compliant with today's tax environment and (although this isn't easy) anticipate expected future changes as far as possible.

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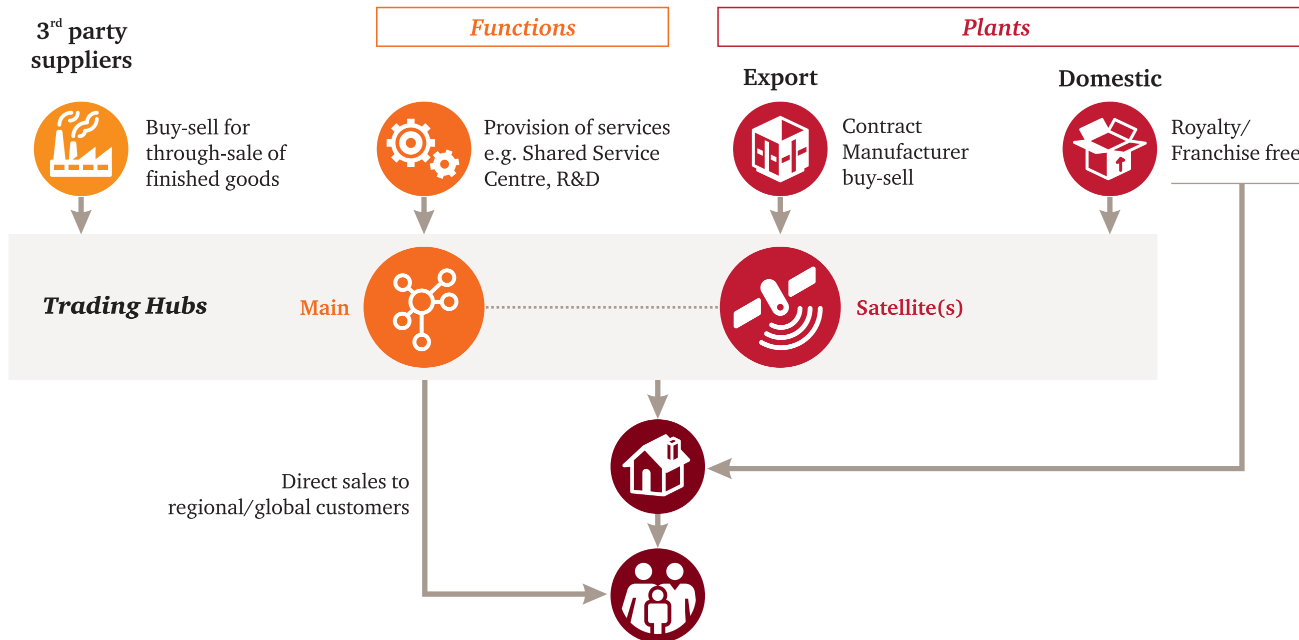


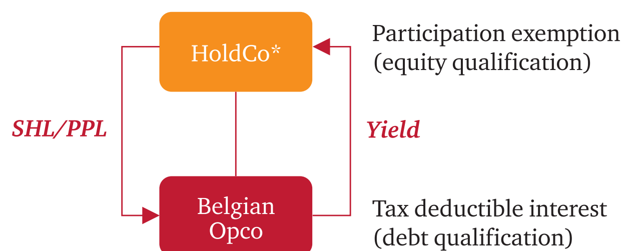
Substance is also key for MNCs with a principal, R&D or financing structure

The globalisation of our economy and the fast development of large ERP systems have had an important impact on the way in which large MNCs organise their value chains. Over the last decade, MNCs have been operating much more globally and the trend has been toward large value chain transformation (VCT) programs aiming to organise operations around large regional or global trading hubs located in key jurisdictions (principal companies and/or R&D centres). While operating in line with existing tax legislations, MNCs have also taken into account incentives and privileged tax regimes that were available in some locations. This trend has also affected the choice of location by groups for housing their treasury function in the sense that many have set up a dedicated financing centre in order to optimise the cost of funding and the cash management of the group (in return for a value added margin).

2. *Hybrid financing*

Hybrid financing is under pressure.

Example of hybrid financing: profit participating loan



** Typically located in the Netherlands/Luxembourg*

Hybrid financing is being challenged by the OECD ...

Hybrid financing instruments feature a mix of debt and equity, mostly leading to (tax deductible) interest for the debtor and (tax exempt) income for the shareholder/creditor. In Belgium, the profit participating loan (PPL) is the most well-known form.

In its Action 2 (neutralise the effect of hybrid mismatch arrangements), the OECD considers ‘double non-taxation’ or ‘long-term tax deferral’ resulting from hybrid financing unacceptable and suggests modifications to the OECD Model Tax Convention and domestic law provisions, as well as unilateral cooperation between jurisdictions.

... and the EU

On 8 July 2014, the EU amended the Parent Subsidiary Directive to avoid that application of the benefits of this directive lead to double non-taxation: the amendment requires that Member States in which the parent company is located tax the yield of the financing instrument if the related costs/payments are tax deductible at the level of the subsidiary (implementation into domestic law required before 1/1/16).

How can you deal with this in an M&A environment?

This new approach to hybrid financing should be duly considered during the acquisition process:

- Hybrid financing within a target group could lead to an unsustainable effective tax rate (ETR) and have a material impact on the financial model.
- Hybrid financing within the EU becomes non-effective tax planning going forward. The feasibility of hybrid financing with non-EU countries has to be analysed on a case-by-case basis.
- Hybrid instruments (e.g. PPLs) – although treated as ordinary loans for tax purposes – might still provide financial solutions for unsteady/delayed cash flows (e.g. Greenfield projects).

3. Strengthening CFC rules

Controlled Foreign Company (CFC) rules are an important consideration in the selection of a location for a holding or BidCo/SPV

CFC legislation within the EU			
Austria	✗	Italy	✓
Belgium	✗	Latvia	✗
Bulgaria	✗	Lithuania	✓
Croatia	✗	Luxembourg	✗
Cyprus	✗	Malta	✗
Czech Republic	✗	The Netherlands	✗
Denmark	✓	Poland	✓
Estonia	✓	Portugal	✓
Finland	✓	Romania	✗
France	✓	Slovakia	✗
Germany	✓	Slovenia	✗
Greece	✓	Spain	✓
Hungary	✓	Sweden	✓
Ireland	✗	United Kingdom	✓

Source: IBFD database

What's in a name?

Controlled Foreign Company (CFC) rules are used in many countries to prevent base erosion (e.g. in the US as well as in some European countries, as shown in the table).

As this is local domestic legislation, rules differ from country to country. Bottom line, CFC rules aim to tax (part of) the (often passive) income of controlled subsidiaries located in other (typically lower-taxed) jurisdictions. Given the variety of systems, the application of CFC rules depends on local definitions (e.g. the notions of 'controlled company' and 'passive income') and local rules (e.g. applicable exemptions and reporting obligations).

In terms of an acquisition, the presence or absence, and concrete application, of a CFC regime is an important consideration when selecting a location for a holding or BidCo/SPV.

Recent developments

In its Action Plan on Base Erosion and Profit Shifting (BEPS), the OECD states that, although CFC rules have been introduced in many countries, they "do not always counter BEPS in a comprehensive manner". On 12 May 2015 the OECD published a Public Discussion Draft including recommendations for OECD member countries. As a result, we can expect countries to amend/strengthen their CFC rules and other countries to introduce CFC rules.

In Belgium?

Currently, the Belgian Income Tax Code does not include CFC rules and, despite rumours, we're not aware of any formal initiative by the Belgian government or legislator to introduce CFC rules into Belgian tax law. Should this be envisaged, it must be clear that CFC rules may not prevent free trade among EU countries.

We’re here to listen

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