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REPORT ON THE TAX ARRANGEMENTS APPLYING TO HOLDING COMPANIES

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1. At the 237th Council meeting held in Luxembourg on 2 and 3 April 1973, the Commission recorded its agreement on a statement by the German and French delegations inviting it to examine, in the report on the adjustment of short-term monetary support and the conditions for the progressive pooling of reserves which it is to put before the Council by 1 July 1973, the problem of the tax status of holding companies.

PART I

Possibilities of using holding companies for purposes of tax evasion

2. Holding companies can serve mainly:

- to control industrial or commercial companies through the holding of major shares;
- to finance the companies in their group by supplying them with funds which they generally obtain by floating bond issues;
- to collect income consisting of dividends, loan interest or patent royalties and licensing fees[1].

From the angle of tax evasion, only the last two functions need to be examined.

Use of holding companies as financing companies

3. The use of holding companies for this purpose is relevant to the extent that major disparities exist between the tax arrangements applied by the various countries to bond income. For instance, if an industrial company established in a country with high withholding tax sets up a holding company which is to float loans in another country with no or only very low withholding tax, this industrial company escapes withholding tax in its own country.

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[1] In some cases holding companies also play the role of investment funds. This activity is of no relevance for the purposes of this report.

Use of holding companies as letter-box companies

4. Foreign taxpayers, especially enterprises, may escape taxation in their country by transferring their assets to a holding company they control (letter-box company) and having the relevant income collected by this holding company. This is possible in particular:

- in countries charging little or no tax at all on this income;
- in countries where income arising abroad is liable to little or no tax at all;
- in countries granting tax privileges to certain types of company, especially if these do not engage in any genuine industrial or commercial activity ("privilege of domicile").

As long as the holding company does not redistribute it, the income collected remains tax-exempt.

But the holding company is not content with holding the income collected. It plays the role of a "turntable" for capital by reinvesting the funds so that they again earn tax-exempt income. To this end it may even place these funds at the disposal of the natural or legal person controlling the holding company, in the form of a loan, i.e. without the formal distribution of dividends. In this way this person enjoys the additional advantage of being able, in principle, to deduct from taxable income the loan interest paid to the holding company.

Even if the income is formally distributed by the holding company, taxation of this income in the hands of the recipient is not guaranteed where withholding tax or other measures of tax control do not exist. Moreover, the countries concerned generally supply no information on

holding companies to foreign tax administrations to the extent that these companies do not fall under double taxation conventions.

5. This tax exemption and the possibilities of abusing it are open to special criticism in the case of interest and royalties, for this income is normally deductible from the debtor's taxable income and is therefore not liable to any tax[1].

Criticism is much less well-founded where it relates to dividends collected by a holding company if, as is the case in most countries, this income is liable to corporation tax at the level of the company distributing it. Exemption is then aimed solely at avoiding economic double taxation. Most countries have such arrangements, though often in the narrower framework of parent companies and subsidiaries (Belgium: no minimum share prescribed; Netherlands: minimum share 5%; France: minimum share 10%). Sometimes this exemption is even granted if the subsidiary is not subject to corporation tax (Belgium and France) or if the tax applying to the subsidiary is very low (Netherlands). If this principle is accepted, at least for parent companies and subsidiaries, tax exemption of capital gains on holdings is also justified, for these capital gains derive from the non-distributed (but taxed) profits of the subsidiaries.

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[1] However, a number of countries levy a withholding tax on this income, but in general this tax is appreciably lower than corporation tax.

PART II

Problems raised by holding companies in the Community

Use of holding companies as financing companies

6. In connection with the use of holding companies as financing companies, there are,at present, some major differences between the systems applied by Member States in respect of withholding tax on bond interest. They range from no withholding tax at all to a very high rate of tax.

Luxembourg legislation may well favour slightly holding companies, which are exempt from the usual 5% withholding tax, but other Member States levy no withholding tax in any circumstances (Germany for residents, Denmark, Netherlands). This problem will not, therefore, be solved by isolated action in respect of one or other of these countries, but by harmonizing the various withholding tax systems, harmonization which must affect all bond debtors resident in the Community. This harmonization is already part of the programme adopted by the Council in the context of the establishment of economic and monetary union, and the Commission intends to put forward a proposal along these lines in the near future.

Use of holding companies as letter-box companies

A. Holding companies enjoying preferential tax treatment

7. The Commission has found that within the Community, legislation exists in Luxembourg[1] and Gibraltar[2] granting holding companies preferential tax treatment of the type described in sec. 4 of Part I.

8. In Luxembourg these tax arrangements were introduced by the law of 31 July 1929 for holding companies which do not engage in industry or

[1] In addition to the capital duty of 1% charged at the moment they are formed and when their capital is increased, the holding companies normally have to pay an annual "taxe d'abonnement" of 0.16% on the value of shares and bonds they issue, the minimum payable being Lfrs. 1500.

[2] Companies exercising an activity outside the country pay only an annual tax of 1% on their capital, the maximum payable being £1 500.

commerce and whose sole object is the holding of shares in other enterprises and the management of such shares. These companies may also float bond issues, manage patents or licences, grant loans, purchase bonds, etc.

The income of holding companies - mainly dividends, capital gains, interest and royalties - is exempt from all direct tax. The holding companies are also exempt from withholding tax on the dividends they distribute and the interest they pay. However, they cannot claim for or recover any tax withheld on the income they collect, nor do they qualify for the application of conventions for the avoidance of double taxation.

The phenomenon of holding companies has grown in size in the past ten years, with the number of such companies more than doubling. According to figures supplied by the Luxembourg authorities, it went up from 1 260 in 1962 to 2 114 in 1968, reaching 2 596 in 1970 and 3 198 at the end of 1972. In 1972 alone, it rose by some 400[1].

9. As regards Gibraltar, legislation also exists granting certain holding companies preferential tax treatment. It should be stressed that the EEC Treaty articles on capital movements and the approximation of legislation also apply to this territory.

No figures are available on the number of holding companies in Gibraltar, but there are not thought to be many.

B. Other cases

10. The advantages gained by using holding companies enjoying special tax status as letter-box companies, can also be obtained, with additional benefits, by using companies which are taxed normally. As Luxembourg holding companies are entitled to benefit from double taxation conventions, they cannot recoup withholding tax levied for instance on royalties they collect. But it is possible to escape all withholding tax by introducing into the procedure an intermediary company subject to normal taxation. For the system to work:

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[1] It is difficult to judge to what extent this increase is due to the existence of preferential tax arrangements. Other factors such as capital and exchange market regulations certainly play a major role here.

- the intermediary company must qualify for the application of a double taxation convention with the country where the royalties originate which provides that no withholding tax will be levied;
- in order to escape corporation tax the intermediary company must remit these royalties to a letter-box company exempt from such tax;
- the intermediary company must not be liable to any withholding tax (as is the case in Denmark and the Netherlands for example).

Under such an arrangement it would be more profitable to make use of a letter-box company located in a country other than Luxembourg or Gibraltar, than have royalties collected directly by a holding company established in Luxembourg or Gibraltar.

In some cases it is not even necessary to use an intermediary company in order to benefit from the conventions. For instance a letter-box company located in the Netherlands Antilles and wholly owned by a Dutch company qualifies for the application of the convention concluded between the United States and the Netherlands. Consequently royalties originating in the United States, collected by such a company and redistributed as dividends to the Dutch parent company seem to escape almost all taxation (they would be liable merely to corporation tax in the Antilles at the rate of 2.4 to 3%).

11. To grasp the full scope of the problem under discussion, it should be borne in mind that letter-box companies represent a very widespread phenomenon throughout the world.

Even in Europe, there are countries with far more letter-box companies than Luxembourg and Gibraltar. According to unofficial sources, Switzerland has about 10 000 and Liechtenstein about 20 000 letter-box companies.

Moreover, in some countries letter-box companies may be used to collect trading income, while Luxembourg holding companies may not be used to this end.

Certain countries or territories having special links with Member States also have legislation under which letter-box companies may be set up. This is true of certain countries which are already associated with the Community (Netherlands Antilles) or which under the Act of Accession will be associated on 1 February 1975 at the earliest (Bahamas, Bermuda, etc.), and of the Channel Islands and the Isle of Man. These countries or territories have an autonomous tax status (the United Kingdom, for instance, has concluded double taxation conventions with some of these countries or territories), and the articles of the Treaty of Rome referred to in sec. 9 do not apply to them. The Member States concerned may nevertheless extend the Community rules on the liberalization of capital movements to these countries or territories, which has already been done in some cases (between the Netherlands and the Antilles, and between the United Kingdom and the countries and territories of the former sterling area). Harmonization measures taken in the field of direct taxation, however, could not be applied to them even in this case.

PART III

Conclusions

12. If one wanted to eliminate tax disparities likely to engender distortions in the capital market, and curb tax evasion within the Community, one would have to abolish, as rapidly as possible, those privileges of holding companies which lend themselves to abuse, especially tax exemption of interest and royalties collected by these companies.

Already in 1967 the Commission looked into these problems, but at that time the Council did not consider it advisable to act on the matter.

Action restricted to holding companies within the Community would, however, inevitably touch off a flight of capital to tax havens outside the Community and would therefore fail to put an end to the tax evasion that is the authorities' main concern in this matter. This flight could even be to the benefit of certain countries having special links with Member States. In this case it would be all the more serious as harmonization of direct taxation does not apply to these countries while the measures concerning the liberalization of capital movements may be applied to them unilaterally by the Member States with which they have these links. This is why the Community would have to take parallel action in respect of all tax haven countries.

The Commission has already begun to study this problem in collaboration with experts from the Member States. It is already clear that in order to take such action, very complex problems must be solved. A firm political will is therefore necessary if results are to be achieved within a reasonable period of time.

13. If it is felt that such a complete solution cannot be implemented rapidly, ways must be sought of quickly making a first move in this direction through a number of arrangements likely to improve the present situation. Here, consideration could be given to the following measures:

(a) arranging for cooperation between the tax authorities of the countries concerned and those of the other Member States in order to enable the latter to obtain the information they need to combat tax evasion through holding companies; strengthening cooperation between Member States' tax authorities in order to prevent abuse of the double taxation conventions;

(b) charging withholding tax on any dividends distributed by holding companies within the Community so that this income is liable to some tax if distributed;

(c) charging, in the Member States, a high withholding tax on interest and royalties remitted to companies paying little or no tax on this income so that income arising in the Community is taxed effectively;

(d) introducing arrangements in the Member States on the lines of Belgian legislation under which a presumption arises that the transaction is not genuine and the burden of proof is shifted in such a way as not to fall on the tax administration[1].

Adoption of such measures would not solve all the problems examined in this document. But it would constitute a partial solution which would act as a certain discouragement to tax evasion.

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[1] Under Belgian legislation, interest, royalties and consideration for the supply of goods or services paid by a Belgian taxpayer to a foreign holding company operating under tax arrangements which are not subject to general law may be deducted from taxable income only if the taxpayer proves that this remittance is made in connection with true and genuine transactions and stays within normal limits. Another, perhaps less effective, rule under this legislation provides that the various transactions through which a taxpayer transfers the ownership of capital and movable property to such a holding company can be relied on as against the Belgian administration only if the taxpayer proves that he received true consideration producing a normal amount of taxable income.

14. The Commission therefore arrives at the following conclusions:

(a) As regards the absence of withholding tax on interest payable on bonds issued by holding companies, a solution should be sought in the general framework of harmonization of withholding tax on bond interest.

(b) On the role which holding companies set up in the Community play in their capacity as "letter-box" companies, the Commission, guided by political and economic realities, considers that for the problem of international tax evasion to be solved completely, there must be Community action against all "tax haven" countries. Pending this, subsidiary measures of the type referred to in sec. 12 could be envisaged.