Managing Corporate Responsibility for European Holding Subsidiaries of American Corporations

White Paper

RogerMooreSolutions

Contents

Executive summary

There are a number of issues facing American corporations operating in Europe that do not exist, or exist in a different form, within the US. These differences are caused by the political and social differences that exist between the U.S. and Europe.

Whereas the U.S. is a federation of 50 states, Europe is a patchwork of 50 states where the individual states have their own laws, taxation and interpretation of common rules.

Europe offers American corporations a challenging, yet lucrative market that more and more corporations, and divisions within corporations, are moving into.

Many American corporations have increased their European footprint through acquisition. This has given them access to European markets, to European know-how and a wide range of possibilities. It has also often given them a number of subsidiaries as an inheritance. These could be small sales offices in countries outside the main acquisition centers or it could be various holding or financing companies.

In larger corporations companies are being acquired, merged and divested. Partnerships and joint ventures are created in order to profit from new opportunities. Holding Companies are created either as investment vehicles for investors, for reducing risk or for tax reasons.

Operating companies are, in the most part, well run and are compliant where they operate. The problem usually lies with the unmanned holding companies. These are not the responsibility of a division. They are the responsibility of corporate.

Corporate's problem with these companies is usually that of focus. The Chief Reporting Officer and his team have their focus towards both the Board and the S.E.C. There is not the same focus to the statutory responsibilities in Europe. Lastly, there is not enough awareness or knowledge of the issues involved.

This paper aims at briefly describing some of the issues involved together with a look at what is required to counter the issues.

Europe as a Business Place

The European market is vital for American corporations. Its size and purchasing power are the clearest signs for this. The GDP of the European Economic Area is greater than that of the US (USD 18 trillion against USD 15 trillion)[1].

Before looking at Europe it is a good idea to define what is meant by Europe.

The Council of Europe uses the geographical definition of Europe as a basis for full membership. On this basis Kazakhstan is eligible for full membership.[2] This definition of Europe gives 50 states as eligible members if we exclude those states that have limited recognition (e.g. Kosovo).

27 of these countries are members of the European Union. Of these 17 use the Euro as currency. Norway, Iceland and Switzerland are not members of the European Union, but have agreements that treat them as though they were insofar as business and trade are concerned. Croatia is expected to be a member from 1 July 2013. Iceland, Macedonia, Serbia, Montenegro and Turkey are all candidate countries to the Union.

Each country is a sovereign state with its own governments and tax laws. Although countries are willing to cooperate and unite in various projects, each country looks after its own interests. This has resulted in a patchwork Europe that can be summarized in the diagram below.

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[1] IMF World Economic Outlook. Retrieved 15 October 2012.
[2] Kazakhstan is eligible full membership of the Council of Europe as 4% of its surface area lies to the west of the Ural River. II General information, point 11 on Council of Europe document 11007 dated 07 July 2006 at http://assembly.coe.int/Main.asp?link=/Documents/WorkingDocs/Doc06/EDOC11007.htm

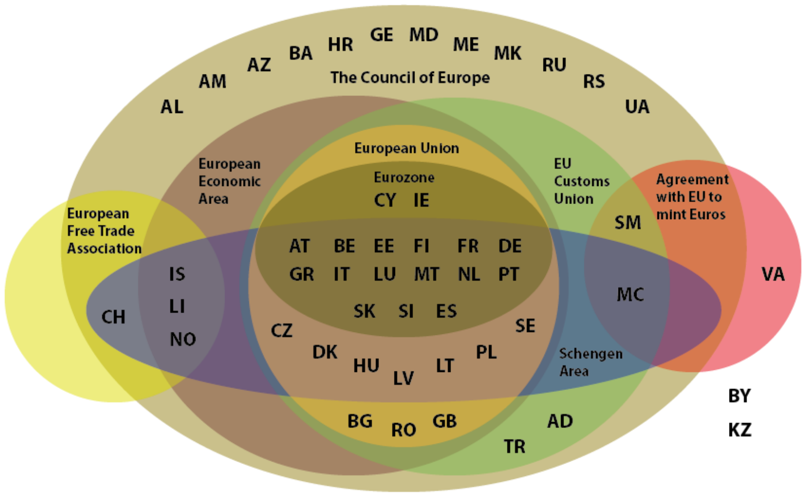

Figure 1: The 50 European states with their main areas of cooperation.

The European Union has harmonized a large number of rules, laws and industry standards, although there can be local differences and interpretations. Many of these are copied into countries outside the union as these countries want access to the single market.

Governments across Europe are all trying to attract investment and jobs on the one side, and to maximize tax income on the other. This gives rise to both possibilities and pitfalls for American corporations.

The possibilities lie in tax opportunities that often define American corporations' European structures.

The pitfalls are that transactions and activities across Europe can create taxable situations that American corporations do not always expect. Therefore good corporate compliance management is an essential part of doing business in Europe.

Bad compliance management can be expensive if a company is caught by the tax authorities. Up to now this has happened to some companies but many have been lucky. Today, governments are pressed for tax income. Increasing taxes is unpopular, likewise cutting services. Increasing revenues from non-compliant multinationals is both profitable and popular so this is an area where all governments are putting in extra resources and beefing up legislation. The message is clear – expect to be controlled.

Compliance issues

Transfer Pricing

This is probably the most well-known problem of cross-border transactions. Multinational corporations must document and prove that transactions made between entities within the concern, are done in accordance with arms-length principles. Documentation should be complete and, as a minimum, cover the following points:

- A description of the concern and of the relevant business.
- A description of the controlled transactions including the terms of business.
- A description of how the pricing of the controlled transactions is made.
- A comparison of the pricing of the controlled transactions against an accepted comparable. This may be an internal comparable but an external comparable is better.
- Tangible inventory sales are not necessarily the only controlled transactions. Management fees, intercompany loans, use of patents and trademarks are all possible transactions.

Transfer pricing documentation should be regularly updated and, as a minimum, at least annually.

Not having documentation is risky today but will not be an option going forward. There is a movement in Europe towards making control that documentation exists part of the audit process. At the moment that does not include an audit of the documentation but this could be a requirement going forward.

VAT

VAT is applied in all European countries and, although it is very similar everywhere, there can be local differences.

The differences are mainly in the amount to be charged or in what is chargeable.

VAT can be recovered by VAT registered companies.

Most VAT is simple and there are very few issues with it. There are a few areas where multinational corporations should be careful.

- Most holding companies have no VAT-rated activity and therefore are not VAT registered. This also means that they cannot recover VAT.

- Outsourcing of warehousing from one country to another. If ownership of the goods is not transferred then the company must register for VAT in the other country.
- VAT returns are normally completed in the local language of the country. English returns are not normally an option.

Permanent Establishment

A company can create a permanent establishment in another country. This happens when a company has a fixed place of business in another country. This would require the company to pay income tax on its earnings in that country and register, report and pay VAT in that country.

The term "permanent establishment" includes especially:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop, and
- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources[3]

Examples of these activities are:

- Employing a salesperson in another country where the salesperson has the authority to conclude contracts with customers. The tax authorities tend to look at the de facto situation as opposed to the legal situation. If the salesperson concludes a deal that only requires the signature of a non-resident director then the tax authorities would deem that the salesperson has the authority to conclude the deal. Therefore a permanent establishment would exist.
- Using a 3rd party logistics where ownership of the goods stays with the company. If this 3PL supplier has its activities in another country from the company utilizing them then there would be a permanent establishment in that country.

Not recognizing a permanent establishment may lead to double taxation.

Substance

Having a company in a particular country does not necessarily mean that it is taxable in that country. If the company is deemed to have

[3] OECD Model Tax Convention on income and Capital. Article 5.

“no substance” then it could be taxable in its parent’s country (or even higher up).

The question of substance is one of where the company is really run from. Most questions of substance take their roots from the double-taxation treaties between countries which are largely based on OECD standards.[4]

This has only a real meaning for holding companies. Operating companies of various types are usually defined as being resident due to having a permanent establishment. A holding company, on the other hand, being run from a postal address with no local director; and no activities, except those of a financial nature to only internal companies would be seen as having no substance. It would be seen, rather, as an extension of its parent company.

To give a company substance the following pointers are usually the minimum requirement:

- Shareholders meetings held at least once a year (this is often a legal requirement for a company) in the country of the company.
- At least 50% of the directors of the company should either be resident in the country or should regularly visit the country in order to exercise their duties. These directors must have rights to exercise their authority and at least to the same level as those non-resident.
- A bank account in that country.

Documentation, signed and dated, should be kept of all meetings and decisions. These should be kept on the premises of the company. If further actions, such as a part-time bookkeeper are added then this improves the substance.

Failure to have substance can mean that the tax authorities of the parent company will claim the right to tax the company and that the tax authorities of the company itself will also do so. This may lead to double taxation.

Statutory Reporting

Generally speaking all limited companies and partnerships are required to complete annual reports and, in most cases, to file these with the local authorities within a defined time period. Failure to file these reports correctly often leads to fines and can lead to

[4] OECD Model Tax Convention on income and Capital. Article 5.

disqualification as a director. It should be noted that fines are normally for the director(s) of the company personally and not the company itself.

European countries have rules applying to when a company should have its books audited. For most multinational companies this means that holding companies and small sales offices do not have an audit requirement while all other companies do.

Functional Currency

One of the issues connected with statutory reporting is that of the functional currency applicable under US GAAP. Holding companies are normally defined as being a direct and integral component of the parent company's operations. This means that they have the parent company's currency as the functional currency (FASB 52)[5]. This means that they could be using USD as a functional currency for US GAAP reporting. However, for statutory reporting, the local currency of the country would normally be applicable.

It is possible, in some cases, to alter the currency for local statutory reporting. However, the rules for this vary from country to country and can mean that all daughter companies (and anything else under the company) must be reported using the same currency.

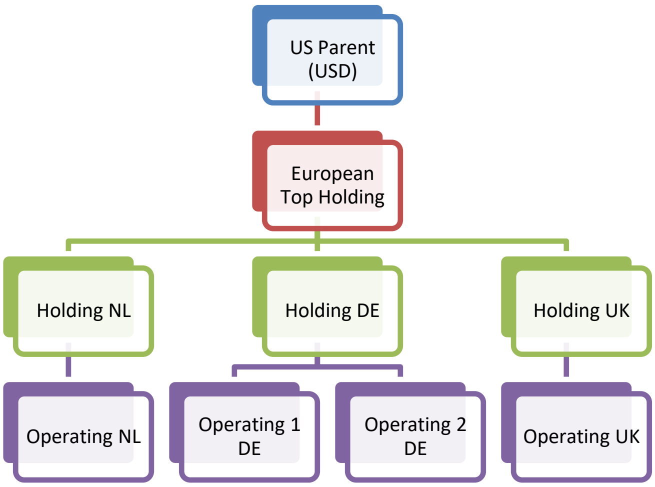

Figure 2: Example of European holding setup.

Looking at the example above and assuming that all the 4 European Holding companies are used solely for financing and tax purposes and have no staff and no other activities then:

[5] Financial Accounting Standards Board: Statement No. 52

- European Top Holding would have USD as its functional currency. For statutory reporting purposes the currency of the country where it located would be its functional currency.
- Holding NL, Holding DE and Holding UK would also inherit the functional currency of their parent (European Top Holding) and have USD as their functional currency under US GAAP. For statutory reporting purposes Holding NL and Holding DE would use EUR and Holding UK would use GBP.
- All 4 operating companies that are dependent on the economic environment of its location would have their local currency as the functional currency under US GAAP.

Having more than one functional currency requires having more than one set of books.

Other currency issues

It is often assumed that if a holding company has a functional currency in USD for US GAAP purposes then loans made to and from this company in USD have no currency issues. This is not correct.

If a holding company in Germany has a loan from a holding company in the Netherlands in USD and both companies have USD as their US GAAP functional currency then there will be no foreign exchange differences as far as the transactions are concerned under US GAAP.

Both companies, however, will have a statutory reporting to be made in EUR which is the basis for their tax returns. Although the foreign exchange gain and loss will be the same and cancel each other out there is a difference in the tax rates. In Germany the rate is 30.175% and in the Netherlands it is 25%.

This is one example but there are many other combinations. Some of these can be positive and some negative.

Another consideration can be to look at the functional currency used for local GAAP. Rules vary from country to country on if and how this can be applied. In the Netherlands it would rare to choose USD as the functional currency as all companies underneath the chosen company must utilize this as their functional currency. This would normally hit one of the operating companies. Denmark, for example, allows the choice of one company which could mean that the holding company used USD and the operating company could use DKK (or even EUR).

Thin Capitalization

Thin capitalization of holding companies can easily create a tax issue in many European countries. Rules vary very much from country to country. The result of this can be that interest deductibility on intercompany loans can be an issue.

There are a number of triggers that cause this. The definition of thin capitalization varies enormously and some countries do not even have rules in place on this.

The problem for some holding companies is that they have large loans to service but have no income. This can leave their equity base very low.

Dividend Policy

There are a number of rules in place in European jurisdictions regarding dividends. This can mean that an audit followed by a shareholders meeting is required before a dividend can be paid. As there is a time limit as to how long after the previous audited results can pass this can mean extra costs together with a delay of several weeks or months.

Therefore it is a good idea to put a dividend policy in place, especially for the operating companies that are usually the most costly and time consuming to audit.

A dividend policy is a good vehicle for putting cash and capital in place within the holding companies. This can be particularly useful if the corporation is investing in new acquisitions in Europe. Alternatively, if there is an issue with thin capitalization in any of the holding companies.

This policy should be put together closely with expert tax advice.

European taxation

One of the drivers in the structures created for European entities is taxation. For US corporations a rate of over 35% is usually the level paid. If earnings can be kept outside of the US then lower rates can apply.

The following table shows the corporation tax rates for certain countries. These are the headline rates and should be treated as such.

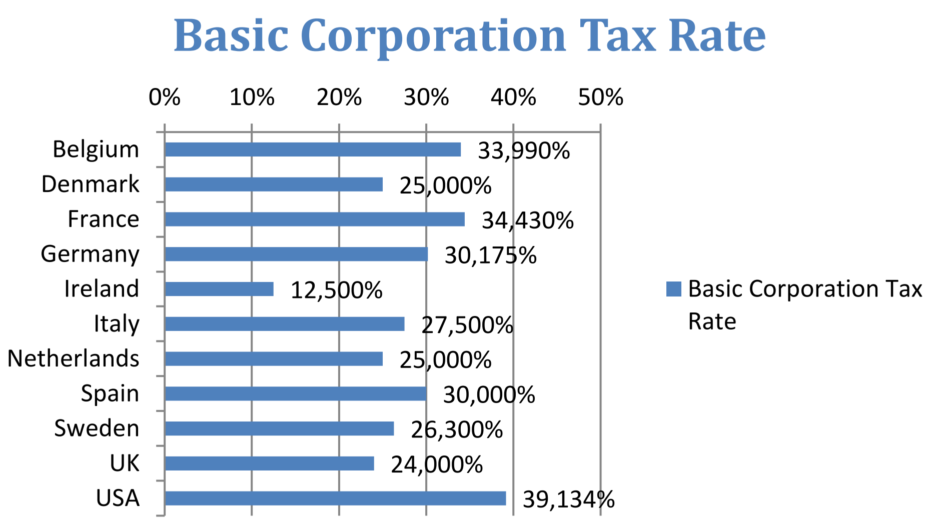

Figure 3: Corporation tax rates 2012[6]

At first glance it is difficult to see why Ireland does not get all investment. However, not all income is taxed at 12.5%. Income from interest and a variety of other sources is charged at 25%.

However, this is one indication as to why Ireland, the UK and the Netherlands are often used as European corporate centers.

Other factors in choosing where to place headquarters are the availability of qualified staff, the distance to a major airport and the location of the other business units within the corporation.

6 OECD Basic (non-targeted) corporate income tax rates for 2012. http://www.oecd.org/tax/taxpolicyanalysis/oecdtaxdatabase.htm

Last, but not least, levels of withholding taxes on dividends and interest, together with tax carry back / carry forward rules are also very important factors.

Check the Box

Generally speaking, US corporations are taxable on their worldwide income. Corporations, however, can defer tax on their foreign earnings by earning it through a foreign subsidiary.

This is limited in that if a foreign subsidiary has a passive and/or mobile income then this is immediately taxable in the US as required under Subpart F of the tax code.[7]

Examples of such income are interest, dividends, royalties or gain on sale of stock. In other words income not gained by an active operating business.

Under US corporate income tax rules an entity may elect to be treated either as a corporation or to be disregarded for tax purposes in the US if it is not of a type that must be treated as a corporation.[8] This process is called Entity Classification Election but is normally referred to as "Check The Box".

A disregarded entity is treated as an extension of its US owner and therefore the taxes paid to any foreign government create tax credits for the US owner as their income is not treated as Subpart F income.

This is a vital part of avoiding double taxation in tax planning for US Corporations wanting to work in the same way that most foreign-owned corporations work.

This rule is one of the major reasons for the creation of holding companies around the world. Without this the tax burden of US Corporations would be so onerous that they would have difficulty competing.

Withholding Taxes

Many countries impose withholding taxes on the payment of interest, dividends and royalties.

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[7] Internal Revenue Code, Chapter 1, Subchapter N, Part III, Subpart F being sections 951-964 http://www.irs.gov/irm/part4/irm_04-061-007.html

[8] § 301.7701-2 Business entities; definitions. http://www.ecfr.gov/cgi-bin/text-idx?c=ecfr&rgn=div8&view=text&node=26:18.0.1.1.2.20.69.2&idno=26

In a number of cases the amount imposed varies according to the type of payment together with the destination of the payment.

Withholding taxes are usually clarified in double taxation treaties.

The Use of Holding Companies

Using our previous organization we can look at why holding companies are necessary.

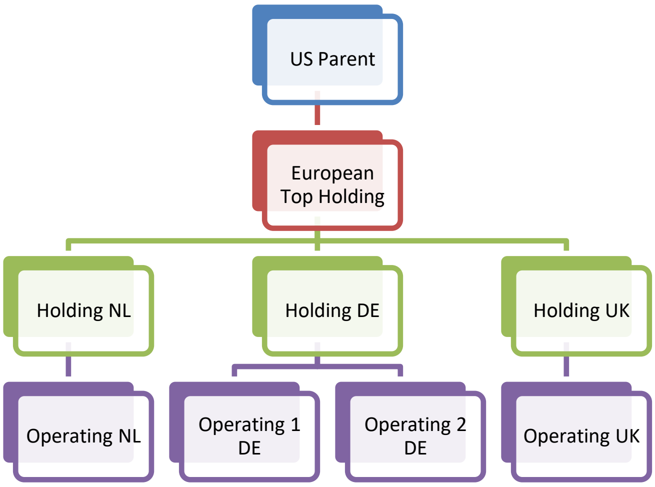

Figure 4: Example of European holding setup.

If Operating 1 DE was sold then the capital gains on this sale would be taxable in the US under Subpart F. However, with the holding company in place it is not subject to US tax unless the gains are repatriated at which time they would be taxable.

Another common use is that dividends can be paid from the operating companies to the holding companies and then lent to other companies within the group without being taxable in the US as long as the money stays outside of the US.

There are other uses of holding companies. One common usage is as owner of intellectual property domiciled in a low-tax jurisdiction

The key to this is to choose a jurisdiction in which to place the European Top Holding. The key requirements are.

- It has double taxation treaties that minimize or totally eliminate withholding taxes on dividends paid to them by the operating countries.
- It has no tax or very low tax on dividend receipts and capital gains.
- It imposes no or very low withholding tax on dividends paid to the US parent.

The Netherlands or Luxembourg are often chosen although other countries (Cyprus, Denmark, Sweden and Norway) are also possibilities.

European Corporate Solutions

There is a complexity involved in doing business in Europe caused by the large numbers of countries involved. It is far from unusual that in a medium or larger US corporation where 10-25% of their sales are in Europe that well over 30% of their legal entities are situated there. A corporation with 250 entities world-wide could see about 100 of these in Europe, and for a larger corporation it is just a question of multiplication. Quite a few of these would be holding companies of various types.

Entity Management

One of the most basic solutions is that of entity management. Just to understand the basics of each of the entities within Europe. Also to set the ground rules for starting, running and closing entities. Some of the basic questions are:

- What is the reason for having this entity
- Who is/are the director(s)
- Deadlines for and latest filings for statutory reporting, tax etc.
- Where should filings be sent to
- Who does filing
- Audit requirement and auditors if required.
- Details of tax advisor responsible for the entity
- Registration details and documentation.
- Articles of Association
- Minutes from the annual shareholders meetings and extraordinary shareholders meetings.
- When a manager leaves the corporation can all companies of which he is a director be quickly found? This is essential in order that he, or she, can be removed from directorships.

These questions are simply with regard to information. Many of these items also require action. Is this being done on a regular and consistent basis? Is there a central data warehouse where all this information and documentation can be accessed by all interested parties within the concern?

There are several systems that can be obtained to do this. At least as important is that the whole process is correctly managed. Without management there will be no consistency in registering data and no consistency in the quality of the data.

Tax Management

Having tax advice in each country that a corporation operates is the normal situation. However, many corporations, often due to historical reasons, have different companies in different countries. Sometimes there can be even more than one tax advisor in a single country.

Because of the amount of international trade, intercompany loans between countries, cross border dividend payment etc. it is imperative that these tax advisors communicate with each other.

The best situation is where one tax advisor sits as the key contact for all tax issues in Europe communicating with all of the others with a hierarchy that mirrors the concern's entity structure.

Bookkeeping and Reporting

It is not unusual for holding companies to be reported in the US with their opening figures and, perhaps, some adjustments for any major changes. Holding companies have the same bookkeeping requirements under European laws as operating companies. Most countries have bookkeeping laws with minimum standards.

With the possibilities created by cloud computing there are a number of solutions for having a simple ERP system that can be accessed from anywhere.

For a corporation without a centralized system this is a cheap and effective solution.

The Benefits of Good Management

It is not sufficient to put the right structure in place and to use good advisors. Like all companies, holding companies also require management.

This does not mean that less advice will be used as the complications in international tax require that management need good advice at least just as much going forward as before. With the tightening up on compliance rules together with the increased focus on cross border transactions there will be an increased requirement for good advice and good management.

Good management of holding companies does cost money. There is no avoiding the cost involved with auditing, tax consultancy and management for example.

Bad management, on the other hand, is far from free. There is the risk of penalties from authorities. There is the risk of unfavorable tax rulings which can result in double taxation. There is also the increased risk of incorrect reporting and possible restatement.

Good management also means that it is possible to optimize the benefits of the structure created.

- Keeping the structure at the right size with the companies correctly placed to optimize the tax possibilities. This means pruning out unneeded holding companies that have outlived their use. Also removing unrequired holding companies picked up through an acquisition or left over after a divestment. The cost of maintaining a holding company without any noticeable activity can easily be $50,000 a year.
- Apart from the direct costs involved in maintaining holding companies there is also a question of corporate governance. The structure should be explainable to the board at any time. It should be remembered that Enron used a complicated structure of about 3,000 foreign entities to hide its losses.
- Being compliant in all markets in which a corporation operates is essential today. Non-compliance can be costly for the corporation’s reputation.
- Tax planning cannot be effectively made unless the basics are in place. This means that it is necessary for the tax department to know and understand the current local GAAP figures. This can lead to optimizing the possibilities existing with different tax rates and rules in different jurisdictions.

Even more important the tax department has a far better position in planning acquisitions or divestments.

- Good management of the holding companies also requires a good dialogue with the operating companies. Outsourcing of processes to third parties can result in creating tax issues. Likewise hiring of personnel in a country where the business has no other operations. Helping to structure these changes can save the operating division considerable problems.
- Far greater accuracy in US GAAP reported figures.
- Unmanaged entities that are hardly ever looked at are more susceptible to fraud.

Roger Moore Solutions

Roger Moore Solutions offers European management of corporate issues to international organizations.

With years of hands-on experience with the issues and problems relating to managing corporate entities, Roger Moore Solutions provides solutions across Europe

Some of the solutions offered include:

- A due diligence process designed to investigate the current European structure. This can evaluate potential weaknesses in the current system together with possible solutions to these weaknesses.
- Implementing an entity management system.
- Creating a unified tax structure across Europe. This could, for example, include an internet portal allowing a wide range of authorized users in different countries to input and obtain data.
- Managing the statutory accounting procedures across Europe.
- Managing the structure of holding companies and operating companies across Europe.
- Implementing an ERP system for European holding companies.
- Managing the booking and reporting (both US GAAP and local GAAP) for European holding companies.

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