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Substance First

Why an intermediate holding company only delivers the treaty rate it was built for when the substance behind it is real and documented.

Holding companies and treaty access: substance before structure

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Holding companies and treaty access: substance before structure

A holding company in a treaty jurisdiction can legitimately reduce withholding on dividends, interest and royalties. What has changed is that the reduction now depends on substance, purpose and beneficial ownership — and each of those has to be evidenced, not asserted.

Who this is for

- Groups with an intermediate holding company between an operating business and its ultimate owners.
- Founders and family offices designing a structure for the first time.
- Anyone whose existing structure was designed before the current anti-abuse rules and has not been revisited.

What a holding company is actually for

The legitimate reasons are real and unremarkable: pooling investments from several jurisdictions, separating an operating business from the assets it does not need to own, providing a single counterparty for co-investors, ring-fencing liability, and creating a clean vehicle for a future sale. Treaty access is a consequence of where the company is resident, not a purpose in itself.

The distinction matters because the modern rules test purpose. A structure whose only discernible reason for existing is to obtain a treaty benefit is precisely the structure the anti-abuse rules were written for. A structure with a commercial rationale that also happens to sit in a treaty jurisdiction is a different animal, and the difference is documented at the time rather than argued later.

Three separate hurdles, and they are cumulative

The first is beneficial ownership. A recipient that is contractually obliged to pass income straight on, or that has no discretion over what it receives, may not be the beneficial owner of that income for treaty purposes — and the treaty rate then belongs to nobody in the chain. Back-to-back arrangements are the classic example.

The second is the treaty's own limitation provisions. Many treaties, and the multilateral instrument that overlays a large number of them, contain a test that denies a benefit where obtaining it was a principal purpose of an arrangement. Some treaties instead contain detailed eligibility tests requiring an active business, ownership by residents, or a substantial connection to the treaty state.

The third is domestic anti-avoidance in the source country, which can apply even where the treaty analysis is satisfied. In practice a structure has to survive all three, and a review that only tests one is not a review. Our page on treaty shopping and beneficial ownership covers the first two.

What substance means in practice

Substance is not a brass plate and it is not a resident director signing documents prepared elsewhere. What tax authorities look for is whether the decisions attributed to the company are actually taken there: board meetings held where the company is resident, directors with the competence and information to decide, minutes that record real deliberation, and a level of local cost consistent with the functions claimed.

Several jurisdictions now legislate this directly through economic substance requirements, with defined core activities that must be performed locally, adequate local expenditure and employees, and annual reporting on whether the test was met. Gulf jurisdictions in particular have developed regimes of this kind. Our page on economic substance in the Gulf covers that pattern.

Hybrid mismatches and the mechanics of getting paid

A structure can satisfy every anti-abuse test and still fail commercially because the two countries characterise an entity or an instrument differently. An instrument treated as debt in one country and equity in the other, or an entity treated as transparent in one and opaque in the other, produces mismatches that anti-hybrid rules now specifically target. The result is often a deduction denied or an inclusion imposed that no one modelled.

The operational side matters too: withholding relief is claimed by giving the payer the right declaration before payment, refunds of over-withheld tax are slow, and a residency certificate takes time to obtain. A well-designed structure with poor administration still delivers cash late.

Reviewing or designing a structure

Purpose first, jurisdiction last. Doing it the other way round is what produces structures that fail a purpose test.

1. **Write down the commercial purpose** What the structure is for, in the words of the people who want it, before any jurisdiction is chosen. This becomes the contemporaneous record that a purpose test asks for.
2. **Map the income flows** Dividends, interest, royalties, service fees and eventual sale proceeds, with the rate each would attract with and without the intermediate company.
3. **Test all three hurdles** Beneficial ownership, the treaty's own limitation provisions, and source-country domestic anti-avoidance. A structure has to clear each one.
4. **Cost the substance honestly** Local directors, premises, staff and professional support at the level the claimed functions require, and whether the benefit still justifies it once that is priced.
5. **Check for hybrid mismatches** How each country characterises each entity and instrument in the chain, and whether anti-hybrid rules deny a deduction or force an inclusion.
6. **Build the annual maintenance routine** Board calendar in the right place, minutes, residency certificates renewed, substance reporting filed, and the payer declarations refreshed.

Papers to gather

What a structure review is built from:

- Current group structure chart with ownership percentages, residence and entity types.
- Constitutional documents for each entity in the chain.
- Board minutes for the last two years, and a note of where meetings were held.
- All intercompany agreements: loans, licences, service contracts and shareholder agreements.
- Dividend, interest and royalty flows for the last two years with withholding actually suffered.
- Tax residency certificates held, and their dates.
- Local cost and headcount for each holding entity.
- Any substance reporting already filed, and any correspondence from a tax authority about the structure.

Where it goes wrong

- **Choosing the jurisdiction before writing down the reason** A purpose test asks what the arrangement was for. If the only contemporaneous record is a rate comparison, that is the answer the file gives.
- **Confusing formal residence with substance** A registered office and a local director who signs what is sent are not decision-making. What is looked for is whether the decisions were actually taken there, and minutes are the primary evidence.
- **Never revisiting a structure that still works on paper** The anti-abuse landscape changed materially, and many structures that were fine when built have not been tested against the current tests. A review is far cheaper than a denied benefit plus interest.

Questions this raises

Is using a holding company in a treaty country legitimate?

Yes, where there is a commercial reason for it and the company has the substance to support the functions attributed to it. What is challenged is a company inserted principally to obtain a treaty rate, with no independent purpose and no real decision-making.

What does a tax authority accept as substance?

Evidence that decisions are actually taken where the company is resident: board meetings held there, directors who are informed and empowered, minutes recording deliberation, and local cost proportionate to the claimed functions. Some jurisdictions legislate a specific list.

Our structure was set up years ago. Does it need reviewing?

Almost certainly. The multilateral instrument, the principal purpose test and the anti-hybrid rules changed the analysis for a large number of treaties, and structures designed before them were designed against a different test.

Can we fix a structure that fails the tests?

Usually, and the sooner the better. Options range from adding genuine substance to collapsing an unnecessary layer to holding the investment directly. Each has its own cost and its own transitional consequences, which is what the review prices.

What to do next

If the structure exists, ask for a second opinion that tests it against all three hurdles and prices the substance it would need. If it does not exist yet, start with the purpose memorandum — it costs nothing and it is the document that matters most later.

We run structure reviews and second opinions as fixed-fee engagements agreed in writing before work starts. Seeholding companies across bordersanda second opinion on an existing structure.

Legal Quotient Consultants

Cross-border and international tax. Fixed fees agreed in writing before work starts, quoted from your own documents.

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