Survey into substance, place of residence and tax avoidance

The place of residence of passive companies acting as a conduit forincome, generally from one country to the other, is hotly debated in countries like the Netherlands, but within the OECD too. Such companies play an important part in group structures, as they use possibly favourable tax regimes and tax treaties to mitigate their tax burden. This may very well lead to adverse consequences for other countries, including developing countries. Two questions are central to this discussion: whether these structures are acceptable (both from a legal and ethical point of view) and whether the place of residence should be dependent from effective management or (other) substance requirements, and, if so, what should the substance criteria be. The Netherlands harbours relatively many of such companies - particularly due to its ruling policy, its tax treaty network and its participation exemption. The Dutch government has formally held on to its policy up to now. This means it wishes to retain the current situation and stay clear of introducing any substance criteria, although parliament especially is pushing for a policy change. That said, the Netherlands does apply substance criteria for certain specific facilities.

Furthermore, there is talk of including general anti-abuse provisions in treaties, such as the main purpose test and the limitation-on-benefits provision. The Netherlands more often accepts the latter provision in the treaties it concludes.

And then there is the so-called country-to-country reporting. The European Commission is taking action on this. The Netherlands has not yet changed its approach in this respect and postpones concrete actions until the European Commission’s document has been published.

Furthermore, the European Commission’s Action Plan in the fight against tax evasion, published on 6 December 2012, as well as its two Recommendations - on aggressive tax planning and good tax governance, respectively - are relevant in this respect.[1] Finally, the OECD has published a report on Base Erosing and Profit Shifting (BEPS) in February 2013. In the summer of 2013, based on the OECD report, the G20 may advise the countries on the measures they could take.

Deloitte has conducted a survey into how the Member States of the EU, the OECD and several other selected states deal with these issues. This survey included the questions referred to below.

The following 23 countries have contributed to this survey:

Austria	Germany	Portugal
Canada	Greece	Romania
China	Hong Kong	Russia
Cyprus	Hungary	South Africa
Czech Republic	Ireland	Sweden
Denmark	Luxembourg	Ukrain
Estonia	Malta	United States

[1] Communication 6 December 2012, COM(2012)722 final, Recommendations 6 December 2012, C(2012)8805 and 8806.

France	The Netherlands	

Please note that the remarks in this report do not necessarily reflect the formal positions taken by the governments of the countries concerned. Instead, they but are interpretations of domestic laws and reproduction of developments in those countries, as provided to us by our local member firms.

a. What are the criteria for determining whether for domestic tax law purposes a company is subject to tax in your country and, thus, entitled to treaty benefits?

In almost all participating countries, a company is considered a resident taxpayer based on (i) its incorporation under domestic law, (ii) its place of effective management, or (iii) both.

Where a company is considered subject to tax under the applicable tax laws, no actual substance requirements are taken into account. That the company was incorporated under domestic law is sufficient. When a company is subject to tax because the place of effective management is in the state concerned, most countries take into account facts and circumstances. This usually is an open standard, but several factors can be taken into account. In almost all cases it would be decisive where the central management is performed and the main business decisions are taken. This is not necessarily the place where the day-to-day management takes place. Other relevant factors that can be taken into account are the place where the directors reside or, more formally, the place of the registered office. Some countries apply only one of above criteria to determine the tax liability of a company, other countries apply both criteria besides each other.

Several other countries do not apply one or both of abovementioned criteria, but refer to the place of registration. France considers a company to be a resident for tax purposes when it has a qualifying legal form and is subject to tax, which seems to refer to incorporation and effective place of management.

None of the responding country firms, though, referred to a requirement to meet specific conditions on governing the presence of factors (e.g., number of employees, office space, certain activities, etc) in order to be considered liable to tax with a sufficient amount of substance.

The following table summarizes the above.

Incorporation (4)	***Place of effective management (1)***	***Incorporation and place of effective management (15)***	***Registration (3)***
Estonia, Hong Kong, Russia, United States	*Denmark*	*Austria, Canada, China, Cyprus, Czech Republic, Germany, Greece, Hungary, Ireland, Luxembourg, Malta, The Netherlands, Portugal, Romania, South Africa*	*Denmark, Sweden, Ukraine*

In addition to this table, please note that most countries stated the place of effective management under bilateral tax treaties to be decisive for determining the place of residence in the event of dual resident companies.[2]

Under Ukrainian tax law registration in Ukraine alone is insufficient. A company should also perform an economic activity on the territory of Ukraine.

b. Are substance criteria part of determining whether a company is subject to tax or whether a company can apply tax facilities? If so, please state these criteria.

Where it concerns determining the tax liability under domestic tax law, countries do take into account facts and circumstances. Virtually none of the responding countries, however, have explicit criteria for determining whether there is sufficient substance. Most countries do apply factors from which it could be derived that the place of management is located in their state, but usually these factors are limited to examining whether important business decisions are taken or the day-to-day management is performed in their country, without taking into account the actual substance of a company.

Luxembourg indicates that sometimes premises, staff and equipment are required to determine whether the place of effective management is in Luxembourg.

Some substance is required in Portugal to determine the place of effective management there. For determining whether there is sufficient substance, Portugal takes into account the number of workers, staff qualifications, equipment owned and other relevant information. The country wants to be sure the company is not a mere shelf company that only wants to benefit from the Portuguese tax regime.

c. Are there any tax facilities where substance criteria play a role, apart from determining the place of residence? If so, which facilities and what are the related substance criteria? (Please pay attention to conduit holding companies and services entities.)

Having sufficient substance is relevant for several provisions in domestic or international law in the various respondent countries. Where it concerns tax treaty provisions, substance is mainly required to determine beneficial ownership, limitation-on-benefits provisions or the main purpose test (see question g).

Under domestic law provisions, substance is mainly required when it concerns transfer pricing regulations, general anti-abuse measures, CFC legislation, interest deduction, conduit companies and the application of the benefits arising from the EU Parent-Subsidiary Directive. The countries applying substance conditions in relation to these measures are specified in the table below:

[2] Usually, this would be agreed under a bilateral tax treaty and not under domestic law. The domestic laws of some countries, e.g. China, have no concept of a dual resident company. When no tie-breaker is agreed under a bilateral tax treaty, dual residency issues are not solved and both countries will treat the company as a resident under the treaty.

Transfer pricing (12)	*Canada, Estonia, France, Germany, Greece, Ireland, Luxembourg, The Netherlands, Portugal, Romania, South Africa, Sweden*
General anti-abuse measures (7)	*Canada, Czech Republic, Estonia, France, Ireland, Malta, Romania*
CFC legislation (7)	*Canada, Estonia, France, Germany, Hungary, South Africa, Sweden*
Interest deduction (2)	*France, Sweden*
Conduit companies (3)	*Czech Republic, The Netherlands, Sweden*
Parent-Subsidiary Directive benefits (3)	*Austria, Germany[3], Romania*

Several countries mentioned substance as being a requirement under their domestic law where it concerns the application of general anti-abuse measures. In cases of sufficient substance (as to what is considered "sufficient substance" cannot, generally, be explicitely specified), a company could invoke domestic tax law provisions without being confronted with exclusion of the application of tax law provisions due to a deemed abuse. Especially in the event that no business reasons have been formulated and the company would only be used for obtaining a tax benefit, certain reliefs may not apply.

Seven countries apply CFC legislation. The general idea of that legislation is to include effectively low-taxed profits generated by non-resident companies in the tax base of the shareholder (either indivual or parent company) without them actually being distributed to the shareholder. Under that legislation, in some jurisdictions, it is possible to provide evidence of sufficient substance in the (non-resident) subsidiary following which CFC legislation does not apply.[4]

France and Sweden apply rules under which interest paid by a domestic company would only be deductible in the event of sufficient substance. French companies attracting a loan for the acquisition of shares can only deduct the interest when they have sufficient substance to demonstrate they actually exercise control over the management of the shares and the management and control of the company whose shares have been acquired. In Sweden, the level of substance of the recipient (domestic or foreign) of the interest is taken into account as a factor for determining whether the loan structure is based on sound business reasons. In case it lacks sound business reasons, interest deduction can be denied.

In Sweden, substance also plays a role where it concerns withholding tax exemptions. In the Netherlands, Decrees state that service entities and conduit companies are excluded from obtaining advance certainty or applying the participation exemption, respectively, because both service entities and conduit companies have insufficient substance. The Decrees prescribes the level of substance a company needs to have in order to be granted advance certainty not to be considered a service entity or conduit company. However, most conditions do not explicitely refer to what should specifically be present in the Netherlands in order to meet the test.

[3] Including treaty benefits.

[4] For German CFC legislation, the substance exemption is only granted if the CFC is located in an EU/EEA Member State. For third country CFCs, only the nature of the income and the level of taxation are decisive.

Austria, Germany and Romania require a sufficient amount of substance in order to benefit from the Parent-Subsidiary Directive provisions.

In Ireland, substance is also relevant to determine whether a company can benefit from the 12.5% reduced corporate income tax rate instead of the 25% passive tax rate. This would also include the condition of having employees in Ireland with sufficient skills to carry on the trade and hold board meetings in Ireland, and of having either an office or shared office space.

d. Are general anti-abuse provisions applied that may be important when determining the residence?

Apart from Greece, the Netherlands, Russia, Sweden and Ukraine, all countries apply some sort of general anti-abuse provision for determining the place of residence.

Two different kinds of provisions are mainly used: (i) a substance-over-form criterion or (ii) a general anti-abuse rule. The substance-over-form criterion is applied to determine whether or not a company is a resident of the country concerned, taking into account the facts and circumstances of a specific situation instead of only taking into account the place of incorporation. The general anti-abuse rule, on the other hand, would lead to no longer being considered subject to tax in abusive situations, even though there would be sufficient substance in the country concerned. Substance criteria can be part of the determination of the presence of abuse. The following table summarizes the applicable provisions.

Substance-over-form (7)	***General anti-abuse rule (10)***	***None (6)***
Austria, Cyprus, Czech Republic, Hungary, Ireland, Luxembourg and United States	*Canada, Czech Republic, Estonia, France, Germany, Hungary, Malta, Portugal, Romania and South Africa*	*Denmark, Greece, The Netherlands,[5] Russia, Sweden and Ukraine*

e. Is a specific policy in place as regards substance in relation to developing countries? If so, which?

None of the countries responding to the questionnaire have a specific policy in place in relation to developing countries.

f. Are certificates of residence issued if the question might arise as to whether the company resides in the country or not? If so, which are the applicable criteria and does this have specific consequences?

[5] On other areas, the Netherlands has an abuse of law regime which applies upon an infringement of object and purpose of the law combined with a lack of other reasons than tax reasons. Whether comparable regimes are effective in the other countries was not examined.

All participating countries would issue a certificate of residence when a company is tax resident in their country. In some countries, issuing the certificate of residence depends on additional conditions. This can be specified as follows:

Place of effective management required (8)[6]	*Austria, France, Germany, Luxembourg,*[7] *Malta, The Netherlands*[8]*, Portugal, South Africa*
Company should be incorporated (5)	*Greece, Hungary, Portugal, Romania, Russia*
Company provides authorities with information (2)	*Cyprus, Ireland*
Dependent on information included in authorities' files (2)	*Canada, United States*
Registration in country (3)	*Denmark, Sweden, Ukraine*
No conditions (2)	*Czech Republic, Estonia*

g. Do treaties include provisions on substance?

Only in exceptional cases, tax treaties include specific substance requirements in order to benefit from tax treaty advantages. Only Czech Republic and France mentioned that some of their bilateral tax treaties include specific requirements regarding the presence of sufficient substance. [9]

However, even though most tax treaties lack explicit substance requirements and a reference to the level of substance, most countries participating in the survey did state their tax treaties include some conditions relating to actual presence or decision-making in order to benefit from the treaty advantages. The requirements most mentioned are beneficial ownership, limitation on benefits and a main purpose test. The following table, summarizes the countries with these conditions and requirements in their tax treaties. Do note that below table only indicates which treaty conditions can be used in some treaties. The requirements are not necessarily included in a country's tax treaty policy.

Beneficial ownership (10)	***Limitation-on-benefits (19)***	***Main purpose test (6)***
Canada, Cyprus, Czech Republic, Estonia, Greece, Hungary, Malta, The Netherlands, Romania, South Africa	*Austria, Canada, Cyprus, Czech Republic, Denmark, Estonia, Germany, Greece, Hungary, Ireland, Luxembourg, Malta, The Netherlands, Portugal, Romania, Russia, Sweden,*	*Canada, Germany, Greece, Hungary, Malta, The Netherlands*

[6] Usually, dual resident companies which are subject to tax in both the state of incorporation and the state where the place of effective management of the company is located. When a tie-breaker rule is applicable, a certificate of residence usually is not granted by the state of incorporation, but merely by the state where the place of effective management is located.

[7] It should be noted, that in case a company incorporated under Luxembourg law with its place of effective management in a country with which Luxembourg has not concluded a tax treaty or with which Luxembourg concluded a tax treaty without a tie-breaker rule, Luxembourg would grant a certificate of residence to a Luxembourg incorporated company.

[8] It should be noted, that in case a company incorporated under Dutch law with its place of effective management in a country with which the Netherlands has not concluded a tax treaty or with which the Netherlands concluded a tax treaty without a tie-breaker rule, the Netherlands would grant a certificate of residence to the Netherlands incorporated company.)

[9] The requirements were not specified further.

	Ukraine, United States	

Additionally, Ireland requires substance to support the existence of a permanent establishment in that country. The Irish tax treaties do not, however, explicitely state what qualifies as sufficient substance.

h. Does the substance criterion apply when assessing the beneficial ownership?

Most countries do not explicitly require substance to assess the beneficial ownership, although this may be an additional factor in the assessment. Most source countries would, however, consider it sufficient for a company to be qualified as the beneficial owner of an item of income while the income is attributable to the receiving company concerned. In their replies, eight member firms indicated that if the receiving company can be considered a conduit company and it, thus, has no authority to decide on its own how the resources received may be used, the receiving company cannot be considered the beneficial owner to the item of income. This concerns Canada, Cyprus, Denmark, Estonia, The Netherlands, Sweden, Ukraine and United States.

Only Austria (to some extent) and Russia indicated that the substance criterion does play a role in assessing the beneficial ownership. In Austria substance alone would not always be sufficient. In the event of tax law abuse treaty benefits can still be denied, even though the company concerned may have enough substance.[10] *Domestic case law is, however, not fully clear on this point. In Russia, the Ministry of Finance explicitely states that a beneficial owner of income for tax treaty purposes must have the right to determine the future economic destiny of the income received. For the recipient of Russian-source income to be regarded as the beneficial owner, physical presence of the decision-makers and infrastructure is crucial.*

i. Is the use of conduit companies substantial? If so, does this meet with resistance, political or otherwise?

The use and presence of domestic conduit companies only seems substantial in Cyprus, Denmark, Hungary, Luxembourg, The Netherlands and Sweden. Only in the Netherlands there appears to be a political discussion on the use of conduit companies, in a situation where a Netherlands intermediate company is only interposed for tax purposes, without any labour effectively being performed in the Netherlands.

In several source countries, the use of (domestic or foreign) conduit companies for optimalization of flows of passive income is being discussed in a political debate. In some countries, like Denmark, France, Romania and Russia, anti-abuse measures have been introduced for reducing, to some extent, tax benefits when conduit companies are used.

[10] Please note that only the Austrian member firm explicitely mentioned this. However, this appears also to be valid for certain other OECD member countries. The Commentary to the OECD MTC allows this and most OECD member countries follow this.

Portugal mentioned that a restriction to the use of the Madeira Free Zone is being discussed.

j. Is the implementation and/or extension of a withholding tax being considered, particularly in respect of capital flows to developing countries? If so, how and at what rates?

Czech Republic recently amended its domestic withholding tax legislation by introducing a 35% withholding tax rate instead of the current 15% on dividends, interest, royalties and some other items of Czech sourced income. The increased rate mainly applies when the recipient is a tax resident of a country outside the EU/EEA with which Czech Republic has not concluded a tax treaty or a treaty on the exchange of information.

Romania also recently amended its tax legislation by introducing a 50% (instead of the current 16%) withholding tax rate applicable to payments made to countries with whom Romania does not have a legal insrument in place regarding the exchange of information (i.e. there is no tax treaty in place with the respective jurisdiction). In addition,Romanian entities may not claim tax credit for taxes withheld abroad, unless Romania has in place a tax treaty concluded with the jurisdiction in place.

Other countries do not consider amendments to their withholding tax legislation. However, six countries mention that tax sparing credits are included in some of their tax treaties, especially with developing countries. They are Austria, Canada, Germany, Luxembourg, The Netherlands and Portugal. The policy in Germany and The Netherlands is to abolish tax sparing credits from tax treaties.

The United States mentioned they do not have tax sparing credits in their tax treaties, but they add that withholding tax rates for developing countries are higher, so these countries can levy more on outbound payments. Portugal, on the other hand, has reduced withholding tax rates in treaties with developing countries.

k. The Netherlands is a staunch advocate of extending the information exchange between countries and it expects a lot from this in the fight against any improper use. Does your country take the same position?

All participating firms replied that their country also seem to favour the extension of information exchange between countries. To the opinion of the Estonian government, however, the extension of information exchange possibilities should not lead to an increase of the administrative burden on the taxpayer or the tax authorities. Hungary remarked that it mainly favours the improvement of the exchange of information in relation to banking secrecy.

Even though the countries appear to be in favour of extending possibilities to exchange information, Portugal and Ukrain added that in practice the exchange of information possibilities are only used in a very limited number of cases. Austria remarked to favour the development, but it cannot be considered a front-runner in this respect.

l. Could you briefly indicate the expectations regarding the policy on the underlying issues during the next five years, taking account of the Communication and the Recommendations of the European Commission of 6 December 2012?

Most respondents could not indicate the expectations for the next few years. In most EU Member States responding to the questionnaire, the local government's position towards the Communication by the European Commission is either unclear or no formal position has been published yet. However, most countries seem to be support the EC initiative.[11] *Therefore, we will limit our remarks by providing an overview of countries that already appear to take action in order to combat tax fraud or evasion.*

Austria: According to our colleagues, the EC's Communication will have an impact on the domestic ruling practice. The domestic tax authorities want to ensure that rulings are in line with guiding ideas of the code of conduct on business taxation and that Austria will not be perceived as a member that provides rulings at the costs of other Member States. Furthermore, the domestic tax authorities are expected to more strictly execute the substance and misuse rules.

Czech Republic: Here some tax treaties are currently being re-negotiated or expected to being re-negotiated. No other developments relating to the Communication and the Recommendations could be mentioned yet.

Denmark and Greece: Both countries mentioned they have started the process of further combatting tax fraud.

All EU Member States would need to adopt the EC recommendation to increase tax compliance and fight tax evasion and to reduce incentives towards indebtedness in corporate taxation.

Summary

As indicated in the introduction, substance requirements are at the heart of the current tax discussions. Countries whose traditional key tax features are their holding company regimes, like Ireland, Luxembourg and The Netherlands, face political pressure to end their domestic tax advantages for companies if those companies fail to have sufficient substance. Remarkeably, none of the responding countries has specified conditions according to which a company has sufficient substance.

Countries do require companies to have sufficient substance for application of tax advantages under domestic laws or tax treaties. Usually, the approach is to apply an open norm that has to be examined for every specific situation. While this provides for a flexible substance requirement, at the same time it lacks legal certainty since it fails to provide for a norm for companies to rely on and apply for tax structures.

[11] Denmark, France, Ireland, The Netherlands, Romania and Sweden mentioned the favourable approach to the EC initiative, even though a formal position has not yet been taken (except for Denmark, where the Minister of Finance explicitly supported the initiative).

Within an EU-wide context several plans have been launched to gradually harmonize, or at least structure, the interpretation of abuse-of-law concepts, like the substance criterion. Many countries favour extending a tax treaty network relating to the exchange of information to achieve a more common approach. Likewise, they favour a more uniform approach to abusive situations. Still, since most countries have not yet formally published their positions on the avoidance of abuse, any concrete measures for the near future are eagerly awaited.