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INSIGHT: International Taxation—Economic Substance and Economic Significance

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How much substance is needed to support the level of taxable profits in a given location? This is a key area of concern for tax administrations and multinational corporations.

There are many areas of statute, guidance and case law that have touched upon the issue of economic substance over the years (albeit not actually answering the question of how much substance is enough) and this article pulls some of these together into a handy summary reference guide for tax administrations and multinational corporations.

Economically Significant Activities and Significant People Functions The 2010 OECD Permanent Establishment (''PE'') report has provided a useful body of guidance for economic substance and transfer pricing with broader application than allocating profits to PEs. The report confirms that:

''a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, must be performed in order to hypothesize appropriately the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises. Under the first step, the functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the PE.''

The report introduced the concept of Significant People Functions (''SPFs'') which has parallels with the Key Entrepreneurial Risk Taking (″KERT″) functions still applied in guidance for Financial Services. The OECD work in this area is extensive and broken down by sector and SPFs are underscored by the following examples that have been pulled from the OECD report:

- assumption of risks;
- acceptance and management or risks;
- economic ownership of assets;
- require active decision-making with regard to the taking on and management of individual risk and portfolios of risks;
- are performed at a high strategic level by senior management or by a combination of centralized and devolved decision-making functions (however this should not just be saying yes or no to a proposal, i.e. economic ownership may also often be determined by functions performed below the strategic level of senior management); and

- managing surplus cash/investments.

Substantial Activities In November 2018, a new Action 5 Global Standard was announced for BEPS inclusive framework jurisdictions to prevent business activities from being relocated to no or only nominal tax jurisdictions to avoid the substantial activities requirement that applies to preferential regimes for geographically mobile income.

These substantial activities are confirmed to include (but not be limited to):

- headquarters;
- distribution centers;
- service centers;
- financing;
- leasing;
- fund management;
- banking;
- insurance;
- shipping;
- holding companies; and
- the provision of intangibles.
  The Global Standard confirms that the activities should be undertaken in the location in question and employees/expenditures related to the activities should be adequate and identifiable.

Contribution to Economic Value Diverted profits taxes have become popular and these often have a Contribution to Economic Value (''CEV'') test that asks whether a transaction has non-fiscal benefits alongside the potential fiscal benefits. It is not the value of the transaction that is being tested with reference to the amount of the tax reduction. The CEV test considers rather what non-tax economic value the particular transaction generates and whether that is greater than the tax reduction. It is a test of the commerciality of the transaction, the value it adds taking into account both its direct and indirect effects, and whether it is entered into mainly for tax or other, commercial reasons.

In defending challenges for clients it is clear that tax administrations are receptive to economic analysis that (objectively) sets out the non-fiscal benefits of a transaction.

General Anti-Avoidance Case Law The 1935 U.S. tax case Gregory v. Helvering introduced the concept of ''Business Purpose.'' If a transaction has no substantial business purpose other than the avoidance of tax then that transaction may be disregarded.

There have been a number of (recent) international cases that look at business purpose and economic substance (or more appropriately commercial reality):

U.K. GAAR 2016 A landmark case in 2016 involved the U.K. tax authority challenging a series of transactions:

- purchase of gold directors by the employing company;
- directors (immediately) sold the gold, settling the liability to pay in return for a director's loan account; and
- long-term obligation was created where the directors had to pay an amount at least equal to the purchase price of the gold to the trustees of an employee benefit trust.
  The transactions led to a tax benefit for corporations and individuals and the General Anti-Avoidance Panel found that the steps were ''abnormal and contrived'' with the sole purpose of avoiding taxation.

Cameco 2018 The Canadian mining company, Cameco Corp. (''CC''), sells uranium to a wholly-owned trading hub, Cameco Europe Ltd (''CEL''). CEL is registered in Switzerland and subject to tax at a lower rate. CEL re-sells the uranium to independent buyers and is highly profitable.

The Canadian Revenue Authority argued that this was a ''sham'' transaction with no commercial basis. However, the court ruled that a sham transaction requires an element of deceit whilst this was a commercial/legal structure and in all essence ''the legal foundation of a tax plan.''

The court also ruled that this was a commercially rational structure and a re-characterization may only apply where arm's length parties would not have entered into the transaction or series on any terms or conditions but instead would have entered into an alternative transaction or series.

The court further cautioned that comparability analysis lies at the heart of the transfer pricing rules and, as a result, any alternative transaction or series identified must be constructed with due regard for all the relevant circumstances in which the actual transaction or series was entered into. The transfer pricing analysis in place was considered to be robust and in line with the OECD guidelines.

Substance and Treaty Benefits Limitation of benefits clauses often cite a target level of financial activity that will be required to sustain benefits. BEPS Action 6 has attempted to clarify a number of relevant concepts.

Main Purpose The concept of ''main purpose'' is often applied in treaties which will deny benefits if the purpose of the entity is solely to obtain a favorable tax advantage. This is consistent with the case law summaries set out above.

Active Trade Action 6 also sets out the risks of limitation of treaty benefits where the resident is not engaged in the active conduct of a trade or business and whether the activity is substantial.

Taxation and Value Creation BEPS Actions 8–10 seek to align transfer pricing outcomes with value creation and (in addition to a helpful body of guidance relating to analyzing transactions) have provided a useful six-step risk control map to assess whether the level of economic substance in a location is sufficient to manage risks:

1. Identify the economically significant risks.
2. Determine contractual assumption of risks.
3. Functional analysis.
4. Assess steps 1–3 in line with current transactions.
5. Allocate risk.
6. Price the transactions.

The BEPS guidance relating to the above has been helpful in bringing some consistency to economic substance and risk management/control (for example—does an entity have the financial capacity to assume risks, formalizing decisions already made may not be sufficient in isolation, etc?).

Favorable Rulings with Tax Administrations on Substance State aid issues aside, historic rulings with tax administrations such as Ireland, Netherlands, Singapore and Switzerland have often included an assessment of future investment, forecast financials, number of people on the ground, capital expenditure, etc (the more people and the more substance, the more favorable the ruling). There are helpful safe harbors with these jurisdictions that set out the types of activity to include:

- board decisions;
- sufficient equity in line with activities performed and risks; and
- holding companies simply receiving income may not be sufficient.

Planning Points The question posed at the outset of this article is, how much economic substance is enough?

In summary, more substance is better than less when attempting to defend a transaction that creates tax arbitrage savings for a multinational group. In fact, if the non-fiscal benefits can be calculated and shown to exceed the fiscal benefits then that should be enough in the majority of challenges.

The above cases also demonstrate that legal ownership and legal arrangements still have force in the world of economic substance if they are consistent with commercial arrangements. Most readers will appreciate that undertaking a transaction or series of transactions for the sole purpose of reducing tax payable will not be supportable and this is not a new concept (reference Gregory v. Helvering 1935) so no amount of substance will help with aggressive structures.

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