Why is economic substance important?

Substance needs to be seriously addressed in order to avoid a high(er) tax burden on your business and to prevent serious tax-disputes arising with your tax authority.

Base Erosion and Profit Shifting

Since the Organisation for Economic Co-operation and Development (OECD) presented their action plan on ‘Base Erosion and Profit Shifting (BEPS)’ the importance of the topic of ‘substance’ has significantly increased. Under the BEPS initiative the OECD counters harmful tax practices, not only of multinational companies, but also of small and medium sized firms that are internationally operational.

Nowadays there are still many structures (in Switzerland) established in such a way that there is so-called double non-taxation, meaning that in both countries there is no effective tax levied on the overall proceeds realised within the structure. The ultimate goal of the BEPS initiative is to prevent the granting of treaty benefits in the case of international corporate structures which are only set up to enjoy the beneficial terms of the applicable double taxation treaties.

In order to achieve this BEPS is addressing a broad range of subjects, including:

- substance requirements under treaties for the avoidance of double taxation,
- anti-abuse provisions in double taxation treaties,
- anti-abuse measures in your home country legislation, and
- so-called ‘Controlled Foreign Company’ (CFC) rules.

All measures relate in one way or the other to the level of genuine economic activity of a corporate structure.

To summarise, in case you are not seriously addressing (local) substance requirements in Switzerland (or elsewhere) in the future, you could be confronted with a considerable higher effective tax burden on your business activity and encounter severe problems with the tax authorities.

Transparency and substance

Based on the OECD recommendations, countries will focus more and more on substance and transparency. This means that under the provisions of treaties for the avoidance of double taxation, tax authorities are increasingly (spontaneously) exchanging information on substance (and this kind of information sharing will further increase in the future) and are also focusing on so-called preferential tax regimes offered by foreign countries. Law makers in your home country are also starting more and more initiatives on this topic since local anti-
avoidance legislation is a rather easy method to fight tax evasion and a good opportunity to increase local tax revenue.

**Prevention of granting treaty benefits**

In case there is no substantial economic activity carried out in the foreign jurisdiction, one or both of the jurisdictions will

- not grant the benefits of the applicable double taxation treaty. This is (or will be) organised by adjusting existing double taxation treaty provisions, or
- implement and apply domestic anti-abuse legislation, such as the introduction of CFC rules or the requirement to disclose aggressive (cross border) tax planning structures.

**Limitation of Benefits clauses**

An increasing number of treaties for the avoidance of double taxation contain Limitation of Benefits (LOB) clauses. LOB clauses are used to address and prevent abuse of treaty provisions. Whenever such a clause applies, the benefits of the double taxation treaty are eliminated. Some LOB clauses are of a more general nature, but most LOB clauses used in the newer (or updated) double taxation treaties are very specific. To give an example: in the protocol of the double taxation treaty signed between India and Singapore one of the LOB clauses states that:

“A resident of Singapore is deemed to be a shell company if its total annual expenditure on operations in Singapore is less than S$200,000 in the immediately preceding period of 24 months from the date the gains arise”

Thus, in case this condition is not met, the company that is interposed in Singapore will be deemed to be a shell/conduit company. The definition of a shell/conduit company under that particular treaty is a company with negligible or nil business operations or with no real and continuous business activities (substance) carried out in Singapore. Such a company is not entitled to any benefits (like the reduction of withholding tax) under that treaty. This means that in the end it will not have any benefit at all when a company in Singapore is interposed if this condition is not met.

**Local anti-abuse legislation**

A good example of local anti-abuse regulations are CFC rules. CFC rules are rules based on which companies located in certain foreign jurisdictions, either fully or partially owned by you or your company, are considered tax-transparent in your home jurisdiction. When a company is considered tax transparent it means the tax authorities ignore its existence and the parent company (or owner) is considered to directly realise any profit made by this subsidiary.

When introducing CFC regulations the tax authorities commonly establish a list of foreign jurisdictions that do not levy corporate income tax at all (tax havens) or that levy tax lower than a certain effective rate (often <10%). In case one of your subsidiaries is located in such a listed jurisdiction, the subsidiary in question could be considered transparent by the tax authorities in your home country in case there is no real economic activity conducted in that jurisdiction.
With CFC rules tax authorities try to differentiate between cross border corporate structures that have a justified business purpose from artificially set-up corporate structures in foreign jurisdictions which have as their only purpose the avoidance of taxation. A lack of economic substance is an important indicator for applying CFC rules.

**Disclosure of (aggressive) cross border tax planning structures**

Local anti-abuse legislation may also stipulate that a company will be required to disclose aggressive (cross border) tax planning structures to its home country tax authorities. These kinds of local provisions effect international tax schemes such as, for example, transfer pricing structures, compensation for intangibles (where is the value of the intangible actually created) or cost contribution arrangements (management fees, head office expenses, etc.). Already a considerable number of countries apply these kinds of rules. You will understand that your local tax authorities will not really be enthusiastic about a structure you have established in a foreign country without any economic purpose…..