

The ideal corresponds to the idea and beauty to form; hence idea and substance are cognate - Victor Hugo

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I am delighted to see that my post on value creation has stimulated discussion on the fundamental thinking about international taxation. See the posts of my friends and colleagues Werner Haslehner and Sergio André Rocha.

At the IFA seminar in Rotterdam, we puzzled over the meaning of “value creation”. Werner also referred to another mystifying term that features in current discussion “substance”.

Substance and treaties

The BEPS Action plan called for a realignment of taxation and relevant substance. That use was, in particular, in the context of third country involvement in the bilateral treaty framework “when done via shell companies that have little or no substance in terms of office space, tangible assets and employees.” OECD Action Plan on Base Erosion and Profit Shifting, (2013), chapter 3, page 13.

It is far from clear what general relevance, office space, tangible assets and employees, have to the universal application of tax treaties. Werner Haslehner observes that where these factors are present, the link with a particular state is

more easily established. A curious anomaly emerges where, on the one hand, these factors become essential to establish entitlement to treaty benefits, while on the other hand, their absence is not now viewed as an appropriate impediment to levying tax on profits derived from digital economy transactions.

Substance v substantial activity

Action 5 also called for action to counter harmful tax practices more effectively, taking into account transparency and substance. This elided into a “substantial activity requirement” in the Action 5 Final Report. OECD (2015), Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, Chapter 4.

The final report explains that Action 5 specifically requires “substantial activity” for any preferential regime. This requirement, it says “contributes to the second pillar of the BEPS Project, which is to align taxation with substance by ensuring that taxable profits can no longer be artificially shifted away from the countries where value is created.”

The difficulty is that “substance” and “substantial activity” mean two entirely different things. “Substance” is a qualitative attribute. It denotes the essential character of a transaction, person or thing. In contrast, “substantial” is quantitative. It refers to amount or volume of something. The report provides no explanation of the meaning of these terms. Instead it offers a case by case approach to determine whether “substantial activity” exists in the case of IP regimes and for certain non-IP regimes.

In relation to the non-IP regimes identified, “substantial activity” seems to refer to the relevant functions that are necessary to perform, along with the assets needed and risks that are assumed, to generate the kind of income in question. The cataloguing of these inputs is not a quantitative exercise. It is simply identification of inputs by reference to their relevance. The absence of relevant inputs is one of the secondary indicators (“other factors”) in deciding whether a tax regime is harmful or not. If the inputs provide the essence of the activity, then they constitute the substance of that activity. That means the activity is of a kind demonstrated by the inputs.

Substance v form

This approach was recently taken by the US Tax Court in *Reserve Mechanical Corp., f.k.a. Reserve Casualty Corp. v. Commissioner of Internal Revenue*, T.C. Memo. 2018-86, 18 June 2018. In that case the court held that a captive insurance company incorporated in Anguilla and regulated by Anguillan law as an insurance company was not a bona fide insurance company for US income tax purposes: the issue of policies to three related US resident entities did not sufficiently distribute risk; policy arrangements resulted in a near-circular flow of funds and the captive did not face actual risk; policy arrangements were not on arm's length terms; and premiums were not actuarially determined. Similarly, the transactions were found not to be insurance transactions in the commonly accepted sense. They were standard documents in the form of insurance contracts provided by the manager of the captive but not adapted to the needs of the insureds.

It is hardly revolutionary for courts to look at the legal essence of transactions. In the *Reserve Mechanical case*, the contracts were in the form of insurance contracts and the business in the form of an insurance company, but, in substance, they were not what the legal form implied.

Economic substance

In the *Reserve Mechanical case*, the court looked to the legal substance of the company's business as insurance and the legal substance of the transactions it concluded. This is distinguished from the economic substance doctrine formulated by the US courts and now codified in IRC§ 7701(o). Under this principle, a transaction is treated as having economic substance, and therefore respected, only if it changes the taxpayer's economic position in a meaningful way, apart from the tax effects, and the taxpayer has a substantial non-tax purpose for entering into the transaction. Meaningful change and substantial purpose may both embrace qualitative and quantitative aspects.

The role of substantial activity

If there is a role for a quantitative factor in the BEPS framework, it may be in determining the right of states to tax the business profits of non-residents. Physical permanent establishments require a fixed place of business to exist for a sufficient, but unspecified, time. Building sites and construction projects have minimum time periods and the UN Model services permanent establishment requires services to be rendered through personnel or contractors present in a state for a minimum

period.

Substantial activity may feature in a future extension of the permanent establishment definition to include virtual or digital PES. The Israeli “significant digital presence”, for example, is determined among other factors by the number of contracts for internet services with Israeli residents, the number of Israeli users of a digital service and the amount of web traffic by Israeli users (Israel Tax Authority circular on internet activity of foreign companies in Israel, 11 April 2016 (not available in English)).

Accounting principles

As a lawyer I’m not venturing into the meaning or role in tax of substance over form as an accounting principle to give a complete, relevant, and accurate picture of transactions and events. Any volunteers for this?