

Economic substance (3/44/19)

To fight fraud and tax avoidance at national and international level, EU authorities are drawing up appropriate rules and explaining relevant concepts. Recent years have seen member states passing anti-avoidance rules into their national legislation and double tax treaties according to OECD guidelines. These circumstances emphasise the need to assess the commercial content and business purpose of transactions carried out by multinational enterprises. Economic substance is a key criterion we should assess to determine whether a company's profit is taxed where it is really earned and whether there is any tax avoidance. This article explores the concept of economic substance.

Economic substance

In taxation, economic substance is a crucial aspect to be examined in the light of national and international tax law. Economic substance is not a one-dimensional concept but comprises a few interlinked elements. Substance should be carefully assessed by considering all of the group's activities. International practice recognises that in order to have adequate economic substance, a company must provide "existence" at three different levels of structural substance:

1. Management (strategic decisions) – this level examines the place of decision making, the number of management meetings, management staff qualifications and expertise (i.e. appropriate education in decision making), attendance at management meetings, the content of meeting minutes, the existence of relevant documentation;
2. Day-to-day running (daily operations) – this level examines staff roles, how actively they carry out day-to-day operations in the stated jurisdiction and how they report performance;
3. Administrative management (practical aspects of office management) – this level examines the physical existence of an office and staff, freehold or leasehold ownership of property, the existence of equipment and devices, bank accounts, accounting records, corporate communication (email correspondence, use of telephone etc).

We should also assess operating substance (i.e. whether revenues/expenses are artificially shifted to other group companies set up elsewhere) and economic substance (i.e. whether the arrangement/transaction has a business purpose).

All these levels should be checked to determine whether the company is using any artificially created arrangement or making transactions to obtain a tax advantage. To qualify as a tax resident of a particular country, the company must provide a sufficient level of presence in that country. So economic substance affects the scope for applying double tax treaties and national tax rules.

The legal framework

Latvian legislation does not prescribe any criteria the competent tax authorities should assess to identify the level of substance. And no guidelines are available for assessing a company's economic substance. That said, Latvia has passed relevant provisions of EU directives, including the general anti-avoidance rule and a number of anti-avoidance rules in the Corporate Income Tax (CIT) Act. When describing artificial arrangements from a CIT perspective, the lawmaker mentions analysing a company's functions (e.g. only holding a trademark) and how the company performs those functions (the fact that the legal presence and

related requirements, including keeping books and preparing financial statements, the existence of a registered office and the right to sign for the company, are satisfied through external service providers) to exemplify a lack of economic substance.

In applying these rules, tax authorities have the power to examine economic substance and recognise the transaction or the corporate group arrangement as artificial on the grounds that it has been set up for the sole purpose of gaining a tax advantage until the appropriate level of economic substance is reached.

Yet there are countries that regulate economic substance in detail at national level. For example, if a Dutch company is to be treated as having a sufficient commercial substance, then –

- at least half its legally mandated and otherwise authorised board members must be living in the Netherlands;
- the board members living in the Netherlands must have sufficient professional knowledge to be able to carry out their responsibilities;
- the company must have qualified staff capable of duly considering and performing the company's transactions;
- board decisions must be made the Netherlands;
- the company's main bank account must be controlled from the Netherlands;
- documents and files must be stored in the Netherlands;
- the company's address must be in the Netherlands etc.

When it comes to examining transactions with Latvian tax residents and the role that Latvian-registered companies play in a multinational group, the State Revenue Service is likely to rely on foreign practice in choosing criteria for assessing economic substance.