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“Substance” in International Tax—More Important than Ever

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“Substance” is becoming increasingly significant in international tax, and the focus on it is likely to change the way in which acquisitions are structured.

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The term “substance” is heard more and more these days in conversations about reforming the “global tax system.” Tax practitioners are familiar with the term in the context of tax treaties, where countries are showing increased reluctance to allow companies with little actual presence to claim residence for treaty purposes. But substance is playing a greater role in other international tax reform contexts as well.

In order to understand the increased significance of substance in international taxation, some historical background may be helpful.

Background

There is a natural tendency for taxpayers to try to shift income into low-tax channels, and for tax authorities to resist those attempts. In the past, the ability to control this behavior globally has been hampered by the lack of sufficient legal tools to tax transactions in accordance with economic reality—or “substance”—rather than in accordance with the artificial structures in which they are cast—“form.” The U.S. has been something of an exception, as U.S. courts and the IRS have long applied a principle known as “the economic substance doctrine” in analyzing the tax consequences of transactions. Over the years, the courts have used this doctrine to disregard the form of highly-structured transactions that taxpayers have entered into in order to obtain tax benefits without significantly changing their economic position or engaging in meaningful business activity.

Legislation Enacted by Congress

Formerly just a judicial doctrine, this principle was recently codified in legislation enacted by Congress. As codified, the doctrine says that the form of a transaction can be respected for tax purposes only if it makes a meaningful change in the taxpayer’s economic posi-

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tion, and is entered into for a substantial purpose aside from its federal income tax consequences.

The concept of taxing transactions according to their "substance" is not limited to pure tax shelter activity, however. Legitimate business objectives can often be achieved by more than one alternative approach, and the choice among those approaches can be influenced by their expected tax consequences. Even under U.S. law, making decisions based in part on tax consequences is not prohibited, and indeed is the focus of a large tax planning industry comprised of lawyers, accountants, economists, and other specialists, including the authors of this article.

However, when planners try to achieve a tax benefit from a transaction merely by manipulating appearances rather than changing the underlying economics, then a broader principle known as "substance over form" may come into play. For example, the economic consequences of a secured loan may be achieved through a sale and leaseback of the collateral. In a given case, the tax consequences of a sale and leaseback may be more beneficial to one or both parties than those of a loan, and the parties may cast the transaction in that form. But if the economics are such that the sale-leaseback exactly duplicates the effect of a loan (e.g., if the seller has the right to buy the property back at a nominal price at the expiration of the lease, or if the term of the lease exceeds the useful life of the property), then the IRS may apply "substance over form" to recast the transaction as a loan for tax purposes.

Determining Whether a Transaction has Substance

At times, it can be complicated to determine whether a transaction has substance or not. It may depend upon the frame of reference. For example, a transaction between a parent company and its wholly-owned subsidiary can cause a meaningful change in the economic position of both parties, when viewed from the perspective of each party as a separate company. But on a consolidated basis, transactions between wholly-owned entities may not result in any meaningful economic change at all. As a general rule, tax law respects the separate existence of each entity, and applies the same consequences to intragroup transactions as it applies to transactions between unrelated parties.

But the law is also full of provisions that are designed to control transactions that are structured to take advantage of the general rule in order to create tax benefits that are disproportionate to the transactions' economic effects on the group as a whole. For example, the U.S. regulations that govern the taxation of companies filing consolidated returns contain matching rules designed to make the tax consequences of intragroup transactions mirror the overall effect that would arise if the transacting entities were divisions of a single corporation. There are also a number of anti-abuse rules that can be applied by the IRS and the courts to disregard or alter the tax consequences of transactions between related parties.

A different kind of complication exists because some provisions in the U.S. Internal Revenue Code were intended by Congress to apply without any requirement for economic substance. So any determination of the degree of substance required to support any given tax treatment involves a determination of whether the treatment in question falls in the (admittedly narrow) category of transactions where substance is not a requirement.

The International Context

In the international context, several features of the global tax system have made it especially difficult for authorities to control tax minimization efforts that rely on the gap between economic substance and transaction form. These include the following.

Sovereign Autonomy

The very notion of a global tax system has been an oxymoron in the past, as each country's tax system has stood more or less on its own, with relatively few legal or administrative links between the systems of different nations. This reflects the notion that how a sovereign nation chooses to finance its government is its own business. However, it has facilitated corporate structures that break up business processes (such as supply chains) into individual components that can be assigned to different corporations in the group, taxed in different countries, in the way that is most advantageous to the group as a whole. Since each country sees only a part of the overall process, and may not have the resources or inclination or jurisdiction to look to the ultimate economic effects, transactions may be arranged in such a way that income is assigned to a low-tax country, or falls into cracks between tax systems and is taxed nowhere.

Legal Formalism

In many countries (especially those that employ civil law systems), courts will apply the law strictly as written, and as a matter of doctrine will not look behind the words of a statute or regulation to apply it according to the supposed intention of the drafters. This makes it difficult to control tax avoidance using economic substance or substance over form arguments, in the absence of statutory support.

Inconsistent Approaches among Tax Systems

Tax planners have historically been able to exploit differences in the treatment of critical elements of transactions between different tax systems. For example, a particular investment instrument may be treated as creating a debt in one country, while the same instrument is considered to represent an equity investment in another. This enables taxpayers to create "hybrid" instruments, which may generate interest deductions in one country without creating a corresponding income item in the other. Or a country may tax a particular form of entity as a corporation, while another country treats the same entity as a passthrough or aggregate of its members, taxing its income only to the members rather than to the entity itself. This allows the creation of hybrid entities and opportunities for inconsistent income taxation between jurisdictions.

Tax Competition

Countries often seek to attract, or retain, investment in domestic economic activity by offering tax benefits. These benefits can take many forms, from a low generally applicable rate of tax on all forms of business income, to providing credits or exemptions to reward specific activities, such as research and development ("R&D"). Such incentives encourage companies to seek ways to secure the benefits of the incentives, without commensurate changes in the way they conduct their businesses.

International Efforts

Efforts are underway internationally to reduce taxpayers' ability to exploit these characteristics. The OECD's base erosion and profit shifting ("BEPS") initiative, subscribed to by over 100 countries, is focused explicitly on these issues. The European Commission is proceeding in parallel with its own initiatives, including the Common Consolidated Corporate Tax Base ("CCCTB") and measures to deal with hybrid mismatches. Important features of each of these measures are discussed below.

BEPS

Substance is one of the three "pillars" of the BEPS initiative, stated as "Pillar II: re-establishing the link between substance requirements and international taxation standards." It is also a core element of three of the BEPS "minimum standards", which are:

- Action 5, *Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*. Specifically, Action 5 looks at the notion of substance in the context of "preferential tax regimes" such as patent boxes and other intellectual property ("IP") regimes. It aims to reduce or eliminate the benefits of tax planning that assigns income artificially to jurisdictions where it will be favorably taxed. Under Action 5, benefits from IP regimes should be proportional to actual expenditures by the company receiving the benefits. So, for example, the company that benefits from an IP regime should actually perform the R&D, not outsource it to a related company.
- Action 6, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*. This action seeks to restrain the use of tax treaties to achieve double non-taxation of income, such as the use of commissionaire arrangements to shift profits out of the country in which products are sold and consumed. The European Union ("EU") has proposed addressing such issues with formulary apportionment, discussed below, under "CCCTB".
- Action 13, *Country-by-Country Reporting*. Referred to as "CbCR", this is an adjunct to the effort to apportion profits in relation to economic activity, such as by formulary apportionment. CbCR will collect information about the location of corporate activity and the factors by which income is apportioned or allocated among jurisdictions.

CCCTB

The CCCTB proposed by the European Commission is described as "a harmonised system to calculate companies' taxable profits in the EU." Its features include:

- mandatory use by large corporate groups;
- filing of a single consolidated tax return for all EU activities;
- loss offsets for operations in different countries;
- a common tax base applicable to all EU Member States. Each Member State would fix its own rate of tax, but the rules for computing taxable income would be uniform;
- a super-deduction for R&D costs;
- an "Allowance for Growth and Investment" that will provide a deduction for increasing equity capital, to reduce the bias in favor of debt financing caused by the interest deduction;
- apportionment of profits among Member States based on three equally-weighted factors: assets, labor, and sales (based on destination).

These features will address substance in a variety of ways. Consolidated filing will prevent the artificial splitting of profits among EU companies that are members of a corporate group. The common tax base will reduce incentives for shifting taxable income between jurisdictions, although there may still be low-tax and high-tax jurisdictions based solely on rates. Formulary apportionment is the feature that addresses substance most directly, since it will attempt to allocate profits according to the location of economic factors rather than according to where particular entities are organized or the formalities of contractual arrangements between related parties.

Implications for Deal Makers

Current trends in international taxation are focused on the taxation of business income in general, and not on the treatment of gain or loss from acquisitions. Their focus on substance is likely to change the way acquisitions are structured, however. Incentives for entities to proliferate on the buy side will be reduced by mandatory consolidation, by measures designed to ensure income is taxed in the jurisdiction where income-producing activities are carried out, and provisions to constrain the benefits of preferential tax regimes. Measures to reduce the relative benefit of interest deductions will also reduce the number of transactions that are heavily leveraged with acquisition debt. Although such requirements as CbCR may carry added compliance costs, reform proponents believe these costs will be compensated for by reduced needs for transfer pricing studies and reduced structuring costs.

Overall, there should be a reduced return on investment in highly structured tax planning, though at the margin in M&A transactions tax planning will certainly continue to offer tax-saving structural opportunities. But the focus may shift from where to place entities and how to structure the contractual arrangements among them, to where real economic activity ("substance") can be located to minimize tax exposure and take advantage of differential rates.

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