Business Briefing International Tax Law

July 2016

Editorial

Dear Reader,

I am very pleased to present the second edition of our Business Briefing on International Tax Law.

This Business Briefing is the result of an interdisciplinary and cross-border cooperation focusing on international tax law. The second edition is dedicated to a topic which has frequently resulted in intense discussions with tax authorities: Substance.

Cross-border companies establish international structures to operate internationally. The reasons for the established structure can be varied, e.g. economic, legal, tax, etc. In only a few cases will the established structure be chosen for tax reasons. When the issue of substance is discussed with tax authorities, the question is often whether the company carries out a genuine economic activity or has set up its own business establishment for business purposes in the country in which it is registered.

While the first section of this newsletter provides an overview of the tax and business principles of tax regulations as they relate to substance, the second section presents a summary of the substance tax regulations in Germany, India, Luxembourg, the Netherlands, Switzerland and the United States of America. These overviews have been prepared by experts from our partner law firms in these countries.

In this edition, the reports on other selected issues focus on the Chinese enterprise income tax from indirect property transfers by non-resident enterprises and on considerations of foreign subsidiaries and domestic commercial criminal law in Germany.

I hope you find this edition informative and entertaining.

Best regards,

Helmut König
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Head of the Tax practice group

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I. Tax concept of substance

The domestic tax law of many countries and numerous international tax treaties contain provisions that establish activity and substance requirements. As part of the Base Erosion and Profit Shifting ("**BEPS**") Project, the OECD has proposed numerous measures that would establish such requirements and are designed to prevent international tax structuring geared towards tax evasion and avoidance.

The reasons for selecting a particular structure, transaction or agreement can be diverse. In some situations, they may be of a purely tax nature. To this end, the tax laws of many states contain provisions designed to prevent abusive practices. A taxable person will therefore often be required to show non-tax reasons for the selected course of action. If a structure has been selected solely for tax reasons, the structure will be considered immaterial as a general rule, for the purposes of taxation.

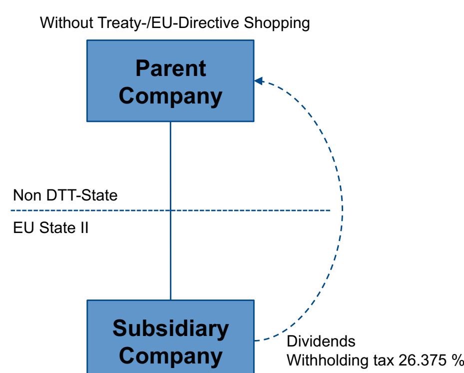
Within the European Union, the principles established in the judgement of the European Court of Justice in *Cadbury Schweppes v Commissioner of Inland Revenue* (Judgment of 12 September 2006 in Case C-196/04, [2006] ECR I-7995) and subsequent judgements must be taken into account. According to these principles, provisions preventing abusive tax practices may only apply where they relate to wholly artificial arrangements, which do not reflect economic reality. A wholly artificial arrangement is assumed where the foreign establishment is purely notional and does not carry our any genuine economic activities there.

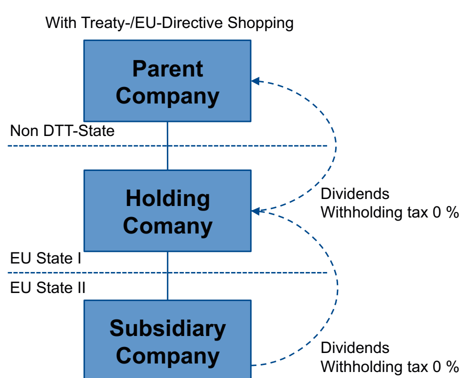
Substance and Withholding Tax

Within the scope of inbound investments, a company's profits from the source state are regularly subject to only limited tax liability in that source state. Many states dispense with the obligation to submit a tax return and instead impose withholding tax. This withholding tax satisfies the tax liability in source state. A double tax treaty ("DTT") between the source state and the country of residence of the company, a EU directive or the national tax law of the source state can all work to reduce or avoid withholding tax.

Treaty and EU Directive shopping represents a chief tax planning technique.

In order to benefit from treaty shopping, a company will involve an intermediate company between it and the source of profits, in order to claim the benefit of the EU directive or the DTT between the source state and the state of residence of the intermediate company.





To prevent the abusive use of withholding tax benefits, national tax laws often contain special provisions, which require the intermediate companies to have both activities and substance in order to qualify for the benefits.

Action 6 of the BEPS Project makes the following recommendations to address treaty shopping:

1. Clarification, that states entering into a DTT are not intending to create opportunities for non-taxation or reduced taxation.

2. A Limitation on Benefits ("LoB") provision.

3. A Principal Purposes Test ("PPT rule").

Under the PPT rule, if the principal purpose of a transaction or agreement is to benefit from a DTT, the benefits of that DTT will be denied. This rule reflects the general principles on preventing abuse that apply in many states.

LoB clauses originate in US Treaty practice and are part of the US model convention. The LoB clause contains alternative tests; the taxable person will only benefit from the DTT if they fulfil one of these tests. The aim of such clauses is to ensure that the taxable person has a close link to the state of residence. LoB tests are based on the legal nature, shareholder structure or activities of a company.

So-called flexibility clauses also belong to the DTT practice of some states. Flexibility clauses in DTTs allow for the application of general or specific national provisions to prevent abuse.

Substance and Controlled Foreign Companies ("CFC Rules")

Lower tax rates in one state or special tax regimes for certain types of income may be incentive for companies to shift profits to a directly or indirectly controlled foreign subsidiary (so-called controlled foreign companies, "CFC"). The tax regimes of many states contain rules designed to avoid profit shifting to controlled foreign companies in states with low tax rates (CFC rules). Yet the CFC rules in some states are incomplete or even non-existent. Action 3 of the BEPS Project therefore contains recommendations for the design of effective CFC rules.

Substance and Permanent Establishments

In many states, the tax law provides that a foreign company in the source state will only have limited tax liability when it maintains a permanent establishment in that source state (permanent establishment principle). According to Article 7(1) of the OECD Model Convention with respect to taxes on income and capital ("Model Convention"), the source state may only tax the profits of an enterprise if that enterprise carries on business in the source state through a permanent establishment, which is located there. The Model Convention also contains a definition of permanent establishment in Article 5. National tax laws and DTTs define permanent establishment in order to simplify the substance requirement for personal tax liability or the distribution of taxing rights. Both of these definitions generally differ. The DTT term is generally narrower than the national concept, so that the right of taxation of the source state is limited in such cases.

As far as tax planning techniques are concerned, the OECD recommends the following measures under Article 7 in order to counteract the artificial avoidance of permanent establishments:

- Commissionaire arrangements and other similar structures;

- An exception in Article 5(4) of the Model Convention for solely preparatory or auxiliary activities;

- Other strategies (e.g. fragmentation).

Substance and the Location of Management

In most countries, the tax law follows the principle of unlimited tax liability. According to this principle, a person will be liable to tax on their worldwide profits in a state, to which they have a particularly close connection. This will normally be the domicile or normal place of residence for a natural person. For a corporation, it will normally be where the company's registered office or executive management are located.

Tax payers can normally only benefit from a DTT if they are domiciled in one of the signatory states. This rule is, for example, enshrined in Article 4(1) of the Model Convention, whereby a resident of a contracting state will be liable to tax in that state. Many DTTs will contain a tie-breaker rule to deal with the situation where the person is a resident of both contracting states (so-called dual residency). The tie-breaker rule establishes criteria to be used to determine the state to which the person has the closer connection. In this respect, it should be noted that residence is the starting point for the distribution of taxing rights. In Action 6, the OECD suggests that the contracting states should determine by mutual agreement, on a case-by-case basis, where the person should be deemed to be resident for the purpose of taxation.

In summary, both, tax liability under national tax law and residency under a DTT, are based on activity and substance requirements. These requirements should be considered within the context of cross border activity.

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II. Substance in selected countries

1. Germany

The requirements for activities and substance play a significant role in German tax law. The question of "substance" is often an issue for tax authorities looking to impose withholding tax or to tax profits of foreign intermediate companies. In addition, there can be negative tax consequences for the relevant company when foreign and domestic companies have the same directors.

German tax law contains general (Section 42 General Fiscal Code (*AO*)) and specific provisions with respect to activities and substance. These are designed to combat tax evasion.

Section 42 AO prevents the use of structures that are primarily motivated by tax avoidance. Accordingly, where this is the case, the structure selected has no significance for tax purposes; instead, the tax calculation will be based on a legal structure that would be appropriate in light of the business activities of the entity. In practice, this provision normally only applies to questions of substance and activities where the company does not have a real function (so-called base companies). Often, special provisions in national law or a double taxation treaty ("**DTT**") will supersede section 42 AO.

Substance and Withholding Tax

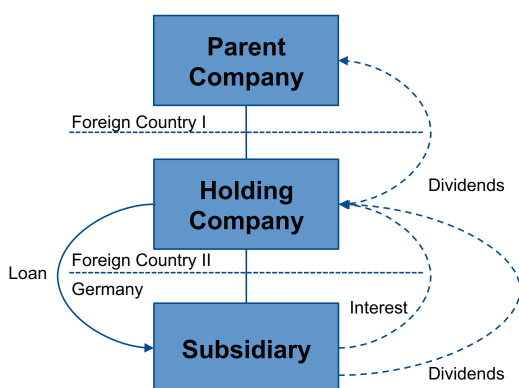
In its *Monaco* judgement of 29 October 1981 (I R 89/80, Federal Tax Law Gazette (*BStBl.*) II 1982, page 150), the Federal Fiscal Court (*Bundesfinanzhof*) limited the scope of section 42 AO to resident taxpayers. In response, the legislators adopted what is today section 50d (3) of the Income Tax Act (*EStG*). This rule is designed to prevent treaty and directive shopping structures. Such structures divert dividends and other payments, such as royalties, through a foreign company with the aim of benefitting from withholding tax relief pursuant to a DTT or EU Directive.

A company has a right to withholding tax relief to the extent that it generates "harmless" income (so-called Earnings and Substance Test (*Aufteilungsklausel*). Income will be considered harmless when:

- the income stem from the company's own economic activities; or
- there are economic or other *bona fide* reasons for the interposition of the foreign company and that company has sufficient substance (e.g. personnel, premises) with respect to the income generated from activities other the company's own economic activities.

Generally, related companies are not considered on a consolidated basis. However, the DTT between Germany and the Netherlands, for example, takes a country-specific consolidated approach. In contrast, current German DTT policy does not take such an approach. Accordingly, if the applicable DTT does not contain a specific rule, corporate restructuring can in some cases increase harmless income. Where the company does not itself fulfil the criteria for withholding tax relief, its shareholders are taken into account. Exemptions also apply for foreign companies that are listed on the stock exchange or which fall under the Investment Tax Law.

From a practical perspective, the rule is particularly problematic for holding companies. The main issue is often whether dividends and other income – e.g. interest and royalties – stem from the holding company's own business activities (so-called management holding company).



DTTs signed by Germany also contain rules designed to limit treaty shopping. Article 28 of the Double Taxation Convention between Germany and the USA, for example, contains a Limitation on Benefits clause (so-called LoB Clause), which requires a close connection to the country of residence as part of standardised tests. German DTT policy allows contracting states to apply relevant national rules (through opening clauses).

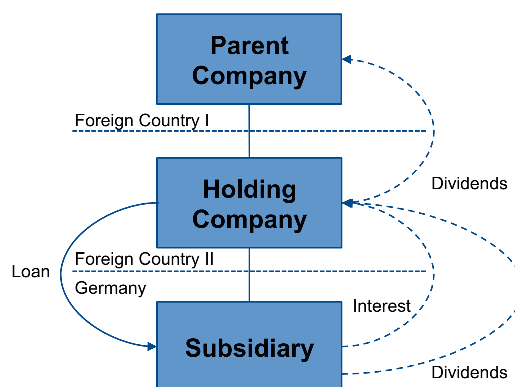
Substance and Intermediate Companies under the Foreign Taxation Act

Since 1972, German tax law has contained rules for the tax applicable to controlled foreign corporations ("CFC") with entities residing in low tax countries. These rules can be found in sections 7 to 14 of the Foreign Taxation Act (*AStG*).

The provisions generally apply when a taxpayer in Germany owns more than 50 per cent of the shares in a foreign company, which has no active income (such as from production), and that income is subject to a tax rate of less than 25 per cent. The rules also apply to downstream subsidiaries, so that intermediate companies do not, in principle, avoid the application of AStG. For individual shareholders, a lower participation requirement (1 per cent) applies to income of a capital investment nature.

If the conditions for the taxation of CFC are met, a notional dividend is attributed to the domestic shareholder. The exemptions for dividend income do not apply. The profits of the foreign intermediary are then subject to taxation in Germany.

In order for the provisions on the taxation of CFC not to apply, the company must have sufficient substance and active activities that fall within certain categories. The activities of a foreign company – e.g. as a procurement company – can be detrimental to income that would otherwise be considered active where that company has a performance relationship with its direct or indirect domestic companies or a related person.

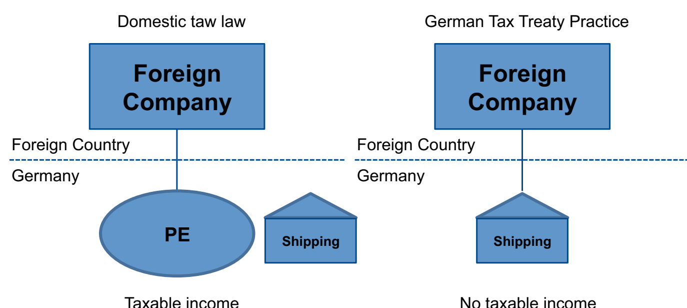


Conversely, this supply arrangement may not be detrimental from a tax perspective where certain criteria with respect to both the activities and substance are fulfilled. In this regard, it is important to establish that the company maintains commercial business operations appropriate to its business activities.

Section 8 (2) AStG also contains an exception with respect to the relevant activity and substance requirements where the foreign company is a resident of the European Union or European Economic Area. This rule is based on the judgement of the European Court of Justice in *Cadbury Schweppes*. As a result, the extent to which any "genuine economic activity" needs to be proven is a "popular" topic of discussion with fiscal authorities. In practice, fiscal authorities tend to set the bar for this proof higher than is really admissible under the principles of the *Cadbury Schweppes* ruling.

Substance and Permanent Establishment

A company will only be subject to limited taxation in Germany when it has a permanent establishment ("**PE**") located in Germany (so-called operating location principle (*Betriebsstättenprinzip*). This concept is commonly given a broader interpretation under national law than is used in DTTs, so that DTTs often limit the application of German taxation law. In this respect, it should be noted that auxiliary and preparatory activities could lead to the finding of a PE under national tax law.



In contrast, DTTs often contain rules, pursuant to which such activities would not be considered sufficient for a PE. As a result, the earnings of such a domestic entity would not normally be taxable in Germany when a DTT applies.

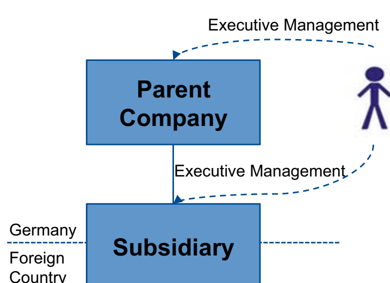
If a domestic entity regularly provides services to a foreign company and is subject to directions from said foreign company when doing so, the entity may be subject to limited tax in Germany (so-called "permanent representative"). Conversely, the application of the relevant DTT can restrict the application of German tax law.

The German Foreign Taxation Act also contains rules for the application of the controlled foreign corporation regime to earnings of foreign establishments. In this case, the credit method rather than the exemption method applies. Similar provisions are contained in German DTT (switch over clauses).

Substance and the Location of the Executive Management

An important criterion – one that is often underestimated in the day-to-day operations of the company – is the place of effective management. A corporation will be fully liable to taxation in Germany – on the basis of is worldwide earnings – when the place of effective management is located in Germany. The place of effective management is located where those persons, who shape the direction of the company, take their decisions. In corporations that operate internationally, executive managers will often take decisions from outside the country where that company is located.

If the most important site (from both organisational and economic perspectives) for the executive management of a foreign company is located within Germany, that foreign company may be subject to tax in Germany. A DTT can also change the residence of the company within the meaning of Article 4(1) of the OECD model and, as a result, change the distribution of rights to tax a company, so that Germany can often tax a large share of the total earnings in such cases.



Conversely, if the most important site for the executive management of a domestic company is located in a foreign country outside both the EU and EEA, section 12 (3) second sentence of the Corporation Tax Act (KStG) may apply, resulting in a fictive liquidation and subjecting the hidden reserves of all assets to tax in Germany. In the case of a company that is deemed to reside in the EU or EEA, hidden reserves of certain assets may need to be disclosed pursuant to section 12 (1) Corporation Tax Act if the German right of taxation is restricted or excluded.

Conclusion

Activity and substance requirements should be kept in mind in cross-border situations as failure to meet the relevant requirements can result in withholding tax benefits not being granted, earnings of foreign intermediate companies being taxed in Germany or the executive management being deemed to be located in Germany. To avoid these tax risks, we advise careful tax planning, proper documentation and monitoring.

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2. India (D C Sejpal & Co)

There is no general anti avoidance provision in the Income Tax Law in India, which gives legal force to the principle "substance over form". Substance over form as a principle has evolved through Court Jurisprudence over the last five decades. However, there are some specific anti-avoidance provisions, which recognize/characterize certain transactions as a specific arrangement and the same is taxed accordingly. Besides, the courts have adopted the principles of interpretation to discourage artificial tax avoidance – the art of dodging tax without breaking the letter, as opposed to the spirit of law.

"Substance over Form" being evolved through Jurisprudence:

India, being a common law jurisdiction, earlier followed the British doctrine that "every man is entitled if he can to order his affairs so that the tax attracting under the appropriate Acts is less than it otherwise would be", which was commonly known as "the Westminster's Principle". A departure from the aforesaid doctrine was made by the Supreme Court in its landmark judgment "McDowell & Co. Ltd. Vs CTO (1985) 54 ITR 148", which was the starting point of the trend. The Apex Court held that it was neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid tax and consider whether the situation created by the devices

could be related to the existing legislation with the aid of ''emerging'' techniques of interpretation. Instead the courts should expose the devices for what they really were and refuse to give judicial benediction. The Supreme Court observed that the proper way to construe a taxing statute, while considering a device to avoid tax, is not to whether the provisions should be construed literally or liberally or whether the transaction was real and not prohibited by the statue, but whether the transaction was a device to avoid tax, and whether the transaction was such that the judicial process could accord its approval to it.

In recent times, in the interpretation of laws in general and of taxation laws in particular, the courts have departed from the ''form'' to go by the ''substance'' of a transaction in appropriate cases. The doctrine of lifting the veil has been applied in India in a number of cases in different contexts. It has been invoked where a corporate entity has been attempted to be used for a fraudulent purpose (P.N.B. Finance Limited vs. Shital Prasad Jain (1983) 54 Comp. Cas. 66 (Del) or to wilfully disobey the court's orders (Jyoti Ltd vs. kanwaljit Kaur Bhasin (1987) 62 Comp.Cas. 626 (Del) or to frustrate sales tax) (Trackways (P) Ltd v. CST (1981) 47 STC 407, 411 (MP)) or capital gains tax liability (Wood Polymer Ltd, in re and Bengal Hotels Ltd, in re (1977) 109 ITR 177 (Guj)) or to deprive the workmen of their legitimate bonus (Workmen of Associated Rubber Industry Ltd v. Associated Rubber Industry Ltd (1986) 157 ITR 77 (SC)) or for other dishonest purposes (Shri Ambica Mills Ltd in re; Jaykrishna Haraivallabhdas (1986) 59 Comp. Cas. 368 (Guj)). The doctrine has also been examined by the Supreme Court in State v. Renusagar Power Co. (1988) 4 SCC 591 and applied to hold that electric power generated by a wholly owned subsidiary company and utilized by a parent company could be regarded as power used by the latter from ''its own source''. The interpretation benefited the company.

Transactions with deceptive characterization

One facet of the principle that the form of a transaction may be ignored in certain circumstances is that the documents should not be construed purely from their legal or technical aspect and by attaching undue significance to the names, labels or words used rather than to the true intention of the parties.

In Union of India v. Gosalia Shipping (P) Ltd (1978) 113 ITR 307 (SC), the Supreme Court held that one cannot place undue reliance on the form which the parties give to their agreement or on the label which they attach to the payment due from one to the other. One must have regard to the substance of the matter and, if necessary, lift the veil in order to see whether the true character of a payment is something other than what, by a clever device of drafting, it is made to appear.

In CIT v. Panipat Woollen & General Mills Co. Ltd (1976) 103 ITR 66 (SC), the Supreme Court pointed out that a party cannot escape legal consequences merely by describing an agreement in a particular form even though it is different in substance. Nor can an assessee by dividing what is in fact a single transaction between two documents achieve the objective which he seeks, nor does he change the nature of the transaction.

The doctrine of substance is attracted if the nomenclature given by the parties to a particular transaction is of no avail. Where the form is held to be immaterial, what is meant is that the misrepresentation of their true rights by the parties as supported by assertions in their private documents or entries in their books of account does not count. For instance, persons who are mere co-owners of a property dividing the net rents amongst themselves cannot convert themselves into partners by merely signing a document describing themselves as partners. Conversely, persons who are partners carrying on a business cannot themselves convert into co-owners by executing an instrument styling themselves as co-owners (Ramniklal Sunderlal v. CIT (1959) 36 ITR 464 (Bom)).

The tension between form and substance assumes importance in those cases, where the essence of substance is not enclosed in the form.The legal rights and obligations in a transaction flow from the terms of the agreement framed by the parties to the transaction. These legal rights and obligations under the general law determine the nature of transaction and the type of legal relationship between the parties.The taxing statute has to be applied in accordance with the legal rights of the parties of the transaction. The authorities cannot tax on the basis of substance, nor can an assesse be let off from tax on the same basis. (CIT vs. S. Ramal Ammal (1982) 135 ITR 292 (Mad)).

However, to tackle certain specific situations, specific anti-avoidance provisions have been enacted up to now, which are summarized hereunder:

Tax Avoidance through international transactions

India adopted the transfer pricing legislation with effect from 1 April 2001, which broadly follows the OECD Model. Although the same does not specifically embody requirements of ''substance'', jurisprudence around it seems to suggest the adoption of a principle of countering tax evasion. Transactions are being challenged based on true facts and circumstances and underlying documentation, as has been seen in Sony India and Rolls Royce decisions.

Avoidance of tax by transfer of income to non-residents

Section 93 of the Income tax law seeks to prevent avoidance of income tax by disregarding a private covenant that would have the effect of transferring income to a non-resident by transferring an asset in lieu of which the transferor acquired any right for the enjoyment of income where the transfer was not proved by the Indian tax payer to be a bona fide one made without the objective of avoiding tax liability. The income from the transferred asset would continue to be taxed in the hands of the transferor. The leading case on the subject is that of Chidambaram Chettiar v. CIT (1966) 60 ITR 28 (SC). The Supreme Court held in that case that this section would also apply to the transfer of assets to a non-resident company in consideration of the allotment of shares to the transferor. The transferor would become liable to be taxed in respect of the income of the company derived from those assets because he had a right, by holding a sufficiently large number of shares, by which he had the ''power to enjoy'' the income of the company whether in the present or in the future.

Indirect Transfers

The question of substance over form in international tax and tax treaty context has often come up before Indian courts in recent times. The Supreme Court judgement in the case of Vodafone International BV (341 ITR 1) declared the law on this subject and supports that in absence of a statute codified anti abuse rule, under judge made common law proposition, the substance of the transaction would be taken into account if the form adopted merely represents a colourable device or a subterfuge or is counterfeit or is a sham. In fact, while reconciling the decisions of McDowells (1985) (54 ITR 148) and Azadi Bachao Andolan (2003)(263 ITR 706), the Supreme Court in Vodafone case observed that the ratio of McDowells may need to be restricted to the case of tax evasion which are through the uses of colourable devices and by resorting to dubious methods and subterfuges.

Here it is important to mention that subsequent to the court ruling in Vodafone, the government had introduced retrospective amendments to tax laws allowing the income tax department to tax indirect transfer of shares if the underlying assets were in India. It also introduced a validation clause that could override any court judgement.

The AAR had also sought to lift the corporate veil in the Sanofi case to tax an indirect transfer of Indian shares under the India-France tax treaty. In this case, the shares of the Indian company were held by a French holding company. The holding company held no other assets other than the shares in the Indian company. The French resident shareholders (the Taxpayers) of the holding company transferred the shares of the holding company to Sanofi Pasteur, a French resident third-party buyer. In a ruling pronounced in 2011 [TS-700-AAR-2011], the AAR had held the sale to be taxable in India under the India-France tax treaty. The Taxpayers filed a writ petition in the AP High Court (HC) against the advance ruling [TS-57-HC-2013 (AP)]. Having regard to the facts of the case, the HC held that the corporate veil of the French holding company cannot be pierced. According to the HC, the French holding company was an independent corporate entity that had commercial substance and business purpose and was not a device for avoiding Indian tax. However, the Apex Court has accepted the special leave petition filed by the Revenue against the taxpayers considering the subsequent amendments made in the law.

Further, in couple of recent advance rulings in the case of Otis Elevators (A.A.R. No. 957 of 2010 dated 22 March 2012) and Z Applicant (AAR No 1048 of 2011), the Authority for Advance Ruling (AAR) arrived at a negative finding on the ground that substance of the matter supported re-characterisation. These cases involved recharacterization of buy back as a dividend and gain from sale of debentures as interest.

Place of Effective Management

Under the Income Tax Law, foreign companies become resident of India if during the year, control and management of such company is situated wholly in India. The amendment was made vide the Finance Act 2015, which states that a foreign company will be treated as a resident of India if its POEM is in India at any point during the year from tax year 2015-16 onwards. Thereafter, vide the Finance Act 2016, the provisions of POEM have been deferred for one more year. POEM is defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made. The above amendment aligns the provisions of the Income Tax Law with the tax treaties, which determines the residence of a company on the basis of its seat of management.

General Anti Avoidance Rule ("GAAR")

Internationally, several countries have codified the "substance over form" doctrine in the form of General Anti Avoidance Rule ("GAAR") and are administering statutory GAAR provisions. In India, the real discussions on GAAR came to light with the release of draft Direct Taxes Code Bill (popularly known as DTC 2009) on 12 August 2009. It contained the provisions for GAAR, which were to be made applicable from 1 April 2012. However, owing to negative publicity and pressures from various groups, GAAR was postponed to at least 2013, and was likely to be introduced along with the Direct Tax Code (DTC) from 1 April 2013. Thereafter, DTC has been scrapped and reworking was to be carried out in respect of GAAR, which is now proposed to be applicable from financial year 1 April 2017.

In the budget by Pranab Mukherjee on 16 March 2012, it was stated that the GAAR is sought to apply from 2015. However, budget 2015 postponed it by two more years.

These are the provisions, which majorly impact international transactions. On similar lines, there are few provisions that target domestic transactions as well. These include Income/Dividend Stripping, clubbing of income of a minor in the hands of the parent, certain specific payments made by a company being termed as dividend, disallowance of business expenses and payments being made to related persons.

Conclusion

The way the doctrine of substance over form is taking its shape in the Indian tax laws and through introduction of proposed GAAR provisions, mechanisms and schemes, which adequately justify substance in cross-border transactions have to be formulated so as to avoid being captured in the gamut of Indian Tax laws.

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3. Luxembourg (Loyens & Loeff Luxembourg Sàrl)

It is a generally applied principle in Luxembourg that transactions are analyzed based on their economic substance if it differs from their legal form. Even though criteria to define substance appear to be limited in Luxembourg and the matter is highly factual, Luxembourg tax provisions frequently refer to this concept. Economic realty is part of several provisions of Luxembourg tax laws. Requiring substance notably intends to tackle tax avoidance and tax evasion but also to assess residency and right to taxation.

Substance in Luxembourg domestic tax law

Luxembourg tax law does not explicitly provide general rules concerning the criteria to assess substance and effective activity.

To date, the only reference to substance requirements in Luxembourg law is an administrative circular targeting Luxembourg companies involved in intra-group financing activities[1] (the "**Circular**"). The Circular issued by the Luxembourg tax authorities specifies the conditions to be fulfilled by these types of entities seeking to obtain binding confirmations from the tax authorities on the remuneration for their financing activities. Pursuant to the Circular, confirmation can only be sought if the company in question is genuinely present in Luxembourg and assumes the risks associated with granting credit. A company may only be considered as "genuinely present" in Luxembourg if it meets all the substance conditions listed in the Circular, including notably having (i) a majority of board members as Luxembourg residents[2] (a company which is a board member must have its registered office and central management in Luxembourg) or (ii) key decisions regarding the management of the company taken in Luxembourg. The conditions detailed in the Circular aim to ensure the effective presence and activity of the company in Luxembourg.

1 Circular LIR n° 164/2 of 28 January 2011 (further clarified in Circular LIR. n° 164/2bis of 8 April 2011).
2 Or non-residents who carry out their professional activity in Luxembourg and are taxed in Luxembourg on at least 50 per cent of their income from those activities.

Even though focusing on Luxembourg companies involved in intra-group financing activities, the substance conditions listed in the Circular are more and more used as general guidelines in practice also for companies engaged in other activities.

Despite an announcement of the Luxembourg government in its program published on 5 December 2013 that general substance rules would be introduced for Luxembourg companies, there have been no further developments since then. The international tax climate and the various EU and OECD projects going on right now may explain this silence, the Luxembourg government obviously waiting for conclusions at EU and OECD levels.

Substance, Effective seat theory and Central Administration

Luxembourg applies the "effective seat" theory to determine the national law applicable to a company. Under article 159 of Luxembourg law of 10 August 1915 on commercial companies (as modified), any company whose central administration (*administration centrale*) is located in Luxembourg shall be considered as being of Luxembourg nationality and shall be subject to Luxembourg law. The place of a company's central administration is presumed to coincide with the place of its registered office, unless evidence to the contrary is brought.

The concept of central administration can also be found in article 159 of Luxembourg law of 4 December 1967 on income tax (as modified). Under this provision, collective entities having either their statutory seat (*siège statutaire*) or their central administration (*administration centrale*) in Luxembourg are considered to be resident taxpayers.

The concept of central administration highly depends on the economic substance. It indeed corresponds to the place where the management is located, key decisions are adopted, accounting books and archives are kept, etc. Economic reality thus takes precedence over legal form.

Substance and Double tax treaties

Double tax treaties ("**DTT**") concluded by Luxembourg generally reflect the OECD Model Tax Convention (the "**OECD MC**") as far as residency is concerned. For companies, conflicts of residence for tax purposes are solved by application of article 4.3 of OECD MC, which refers to the company's "*place of effective management*".

Even if paragraph 24 of OECD MC commentaries provides that the concept of place of effective management has an autonomous conventional definition, it is worth noting the similarity of its meaning with the Luxembourg domestic notion of central administration, both of them converging towards economic substance.

Substance and Implementation of the modified Parent-Subsidiary Directive

Luxembourg has transposed European Union requirements regarding economic substance by implementing, with effect from 1 January 2016, the common minimum anti-abuse rule ("**CAAR**") contained in the modified Parent-Subsidiary Directive ("**PSD**")[3] in its domestic law.

Broadly speaking, the CAAR, as transposed in Luxembourg tax law, requires to deny the benefit of the participation exemption regime derived from the implementation of the PSD to profit distributions[4] that are made in the framework of an arrangement which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the PSD, is not genuine having regard to all relevant facts and circumstances.

Arrangements shall be regarded as not genuine to the extent they are not put in place for valid commercial reasons which reflect economic reality. Economic substance therefore plays a considerably increasing role in the current fiscal environment.

Substance and Luxembourg general anti-abuse rule

Notwithstanding the implementation of the CAAR in Luxembourg law, a domestic general anti-abuse rule was already applicable in Luxembourg, following the implementation of the German tax system in Luxembourg in 1940/1941. Paragraph 6 of the Luxembourg tax adaptation law (*Steueranpassungsgesetz*, "**StAnpG**") enables the tax authorities to requalify transactions in case legal forms and "construction possibilities" in civil law are abusive for the purpose of tax avoidance. It targets transactions driven by fiscal objectives instead of economic reasons.

This provision is more and more invoked by the Luxembourg tax authorities to challenge a structure absent economic substance.

Substance and ownership of assets for tax purposes

Luxembourg tax law also contains a specific provision regarding the ownership of an asset, when the legal and the economic owner are not identical (paragraph 11 StAnpG). In such a case, the asset should in principle be allocated to the economic owner, economic reality and substance outweighing the legal appearance.

Substance and BEPS report

Luxembourg has endorsed the action plan published by the OECD on 19 July 2013. Action 5[5] of the OECD 2015 final report notably deals with transparency and substance in the context of IP regimes and other favorable tax regimes.

Concerning the IP regime, Action 5 refers to the "modified nexus approach" as a requirement for a substantial activity. Under this approach, only taxpayers which incur qualifying expenses giving rise to the IP income can benefit from the IP regime.

In view of the above, Luxembourg voted the abolishment of its IP Regime in December 2015, with effect as per 1 July 2016. The current regime exempts 80 per cent of the income and gains derived by a Luxembourg taxpayer from its qualifying IP (with a 100 per cent net wealth tax exemption for the IP itself).

A five year grandfathering period[6] for qualifying IP created or acquired before 1 July 2016 will apply, with some exceptions or limitations.

A new regime is expected to be announced by the Luxembourg government in the coming months to replace the existing one.

[3] Directive 2015/121 amending the directive 90/438/CEE on the common system of taxation applicable in the case of parent companies and subsidiaries.

[4] Note that the CAAR does not apply to capital gains.

[5] Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5-2015 Final Report.

[6] The grandfathering period starts as per 1 July 2016 and ends on 30 June 2021 for Luxembourg corporate income tax and on 1 January 2021 for Luxembourg net wealth tax.

Conclusion

Whilst substance requirements for Luxembourg companies are generally relevant from a foreign tax point of view, Luxembourg tax authorities have become more and more focused on real presence/substance of Luxembourg companies in cross-border situations during the last years as well. The implementation of the modified PSD and the BEPS Action Plan also confirms the increasing importance of substance requirements in the international environment. Companies should continuously consolidate their effective presence in Luxembourg and ensure that transactions are driven by business reasons reflecting the economic reality.

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4. Netherlands (Ekelmans & Meijer Advocaten)

Recent developments created a political momentum for governments to take a stand against artificial tax planning structures. The Netherlands, which is often used for international tax planning purposes, has introduced guidelines and regulations aimed to ensure that only companies with real economic activities and sufficient Dutch substance benefit from the Dutch tax regime. While the Netherlands have unilaterally introduced these measures, the Dutch government made it clear that a coordinated multilateral approach is needed to combat tax avoidance.

The Netherlands introduced minimum substance requirements for Dutch conduit entities and for companies that wish to obtain a ruling in the Netherlands. Substance requirements play also an important role in the new anti-abuse rules for Dutch cooperatives and for foreign shareholders with a shareholding of 5 per cent or more (i.e. a substantial interest) in a Dutch resident company.

Substance requirements for Dutch conduit companies

As per 1 January 2014 Dutch conduit companies should declare in their annual tax return whether or not they meet a defined set of substance requirements. This rule applies for conduit companies which are considered to be a Dutch corporate tax payer and:

- whose main activity (>70 per cent) involve the intra-group receipt and payment of foreign interest, and rental or lease payments; and
- for which treaty benefits are claimed.

The holding of participations is not taken into account when determining which part of the total activities is performed by the conduit company.

The list of substance requirements can be summarized as follows:

a) at least 50 per cent of the statutory board members should be resident of the Netherlands;

b) the Dutch resident directors should have the required professional expertise to perform their tasks;

c) the company has qualified staff at its disposal for proper implementation and registration of the transactions it enters into. The qualified employees may still be hired from third parties;

d) management decisions are taken in the Netherlands;

e) the company's most important bank accounts are held and managed in the Netherlands;

f) the financial records are kept in the Netherlands;

g) the company's registered office is in the Netherlands;

h) the company is not regarded as a tax resident in and by another country;

i) the company should bear genuine economic risk in relation to its financing, licensing, rental or leasing transactions; and

j) the company should have a sufficient equity at risk, appropriate for its assets and operations.

In the event a conduit company does not meet these substance requirements throughout the year, while claiming benefits under a tax treaty or EU Directive, it is obliged to report this in its tax return and provide additional information allowing the tax authorities to make a proper assessment. In such case the Dutch tax authority will spontaneously exchange the information it receives with the source country, enabling it to determine if the applicable rule can indeed be evoked. If a company fails to provide this information or to do so on time, it will be regarded as an offence and a penalty can be imposed.

Furthermore, the Dutch tax authority will proactively exchange the information of an Advanced Pricing Agreement (APA), with the relevant foreign tax authority if:

- the group of companies to which the conduit company belongs does not perform any other activities in the Netherlands than the activities connected to the minimum substance requirements; and
- the group of companies has no specific plans to increase the substance in the Netherlands.

No Advanced Tax Ruling (ATR) and APA for holding companies that do not meet the minimum the substance requirements

Also as per 1 January 2014, Dutch intermediate and top holding companies in international structures that want to file a request for an ATR in relation to: the Dutch participation exemption, non-resident taxation, hybrid loans and the Dutch dividend withholding tax position for cooperatives, need to:

- either meet the aforementioned minimum substance requirements; or
- should be part of a group of companies which has operating activities in the Netherlands or has genuine plans to do so.

Anti-abuse rules and substance requirements

Pursuant the general anti-abuse rule (GAAR) as introduced in the EU Parent Subsidiary Directive in 2015, the Dutch government revised its anti-avoidance rules in respect of non-resident taxation of foreign corporate shareholders and the dividend withholding tax treatment of distributions by Dutch cooperatives.

Non-resident taxation rules

A non-Dutch resident company with a shareholding of 5 per cent or more in a Dutch company becomes subject to Dutch taxation if:

a) the main purpose, or one of the main purposes of the non-Dutch resident corporate shareholder is to avoid Dutch income tax or dividend withholding tax; and

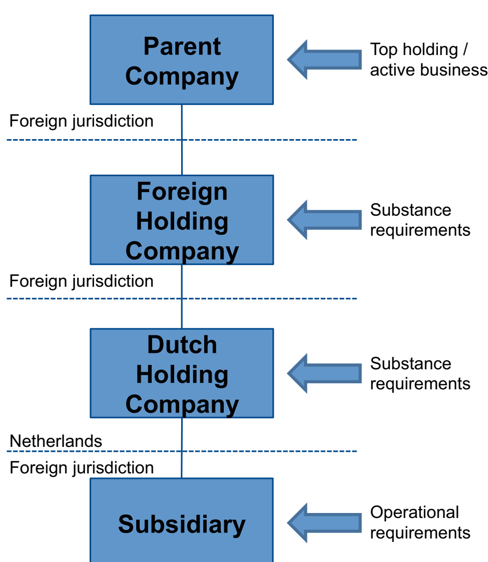
b) there is an artificial arrangement or series of arrangements.

Arrangements are considered artificial to the extent that they are not put into place for valid commercial reasons which reflect economic reality. Following the explanatory notes towards these anti-abuse rules, economic reality is deemed to be present when:

1. the direct shareholder of the Dutch company is running an active business in its home jurisdiction and the investment in the Dutch company is attributable to that business;

2. the direct shareholder of the Dutch company is the top holding company of the group and performs substantial managerial, strategic or financial functions for the group;

3. the direct shareholder of the Dutch company has a linking function between the Dutch company and a company as mentioned in (1) or (2) and the direct shareholder has sufficient substance in its home jurisdiction. Such sufficient substance is present when the non-Dutch resident shareholder meets the aforementioned minimum substance requirements.



Dividend withholding tax for Dutch Cooperatives

Since cooperatives were exempt from Dutch dividend withholding tax, unlike for instance a BV, traditionally many international operating companies used a Dutch cooperative in their structure. The revised GAAR introduced a new anti-abuse rule against abusive co-operative structures. As per 2016, distributions of a cooperative are subject to 15 per cent Dutch dividend withholding tax if:

a) the cooperative holds an equity interest in one or more Dutch or foreign companies with the main purpose, or one of the main purposes, to avoid Dutch dividend with-holding tax or foreign tax; and

b) there is an artificial arrangement or series of arrangements.

Following the explanatory notes, a Dutch cooperative with a real economic function does not fall under the Dutch withholding tax regime. Meaning that a Dutch cooperative that carries on an active business, with employees on the payroll and that has an office to its disposal, would be considered to perform a real economic function.

Conclusion

International operating companies that are using the Netherlands for tax planning purposes should be aware of the importance of substance. Depending on the structure and the purpose of the Dutch company, the Dutch tax authority may want to check if minimum substance requirements are met in the Netherlands, but also at the level of the foreign intermediate shareholder. Not meeting these substance requirements can have adverse tax consequences. The defined set of substance requirements issued by the Dutch government is a warm welcome, as it does give some more clearness for companies on the subject of substance. In the light of the OECD reports and the EU anti-tax avoidance package, it is to be expected that foreign companies can only benefit of the Dutch tax regime if real economic activities and sufficient substance are present in the structure and at Dutch level.

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5. Switzerland (Meyerlustenberger Lachenal)

Substance requirements are usually discussed in two areas of international taxation with a Swiss nexus. First, foreign parent companies of Swiss corporations need to fulfil the requirements of the relevant double taxation treaty ("**DTT**") in order to benefit from a reduced Swiss dividend withholding tax rate. Second, substance criteria play a significant role in determining whether or not a foreign company is subject to Swiss tax: Foreign corporations may become subject to Swiss tax on the basis that they have a permanent establishment in Switzerland or are effectively managed from Switzerland. Conversely, recent court cases dealt with the recognition of a foreign branch of a Swiss company in light of substance of said branch abroad.

Switzerland does not have codified international tax law. Instead, Swiss international tax law is principle-based. A number of court decisions as well as the practice of the Federal Tax Administration provide some guidance on Switzerland's approach to substance requirements in an international context. Many of these decisions are based on a general anti-abuse concept.

Substance and Withholding Tax

Dividends paid by Swiss companies are subject to withholding tax at 35 per cent. Shareholders outside Switzerland may be entitled to a full or partial relief based on an applicable DTT. Thus, substance criteria are relevant in two aspects: The first question is whether or not a corporation is subject to dividend withholding tax according to domestic law. Secondly, it has to be analyzed whether or not the recipient fulfils the requirements of the relevant DTT to recover the tax.

As per the Withholding Tax Act, domestic corporations are subject to the tax. A company is deemed to be domestic if (i) it is incorporated under the laws of Switzerland or (ii) if it is incorporated abroad but managed in Switzerland and carries out a business in Switzerland.

With (ii) above, the legislator aimed at preventing from using foreign corporations to circumvent withholding tax. The place of management is, however, not defined in the law. The Swiss Federal Court defines it as the place where the center of the economic and administrative existence of a company is. The relevant activities under this definition are the actual day-to-day management rather than the ultimate strategic and operational oversight. Interestingly, the place of management in itself is not sufficient for a foreign corporation to become subject to dividend withholding tax – this foreign corporation must also carry out a business in Switzerland. The definition of "business" is, however, rather broad.

Switzerland's DTT are generally based on the OECD model convention. Thus, in order to obtain relief from Swiss dividend withholding tax, a foreign shareholder must be a resident of the other contracting state. Although a few DTT's which were concluded before 1977 do not expressly require that the recipient of the dividend is the beneficial owner of the dividends, the prevailing Swiss doctrine takes the position that the concept of beneficial ownership is implicit to all DTT's. Thus, a relief from (or reduction of) withholding tax is only granted if the *beneficial owner* of the dividend is a *resident* of the other contracting state.

Residency is determined according to the domestic laws of the contracting jurisdictions. In practice, this may lead to a dual residency, and it would go beyond the scope of this essay to discuss such situations. The criterion of beneficial ownership has anyways become the more important in recent years.

Switzerland applies a substance-over-form approach in determining the beneficial owner of income. Therefore, the recipient of the income is not necessarily the person who has legal title to the income, but is the person who is *economically* entitled to the relevant income. Abuse is usually assumed if treaty benefits are claimed with respect to income that is substantially used directly or indirectly to satisfy the claims of persons not entitled to treaty benefits. This applies, in particular, to mere conduit companies. In order to be viewed as beneficial owner of a specific income, the recipient must not have contractual or factual obligations to forward such income to a different person, by way of dividends, interest or fees. Hence, the recipient of such income must be sufficiently equity-financed, usually in excess of 30 per cent. Although the capitalization is not the only test applied by the Federal Tax Administration, it is usually one of the most important ones. Substance in terms of office space and employees in the shareholder's jurisdiction is, of course, helpful to evidence that the structure in place is not abusive. Recent court decisions also held that instruments such as total return swaps or securities lending may be abusive.

In this context, it is important to note that Switzerland has implemented anti-abuse provisions against the abusive claim of treaty benefits by a Swiss company. In summary, the application of a DTT may be declined by the Federal Tax Administration if a Swiss resident corporation forwards treaty-protected income to a person who would not itself be entitled to treaty benefits. Hence, in international structures, substance and beneficial ownership *in Switzerland* may be as important as substance and beneficial ownership abroad.

Substance and Permanent Establishment

A company is subject to limited taxation in Switzerland when it has a permanent establishment ("**PE**") located in Switzerland. According to domestic law, a PE is defined as a fixed place of business in which the business of the (foreign) corporation is fully or partly carried out. In terms of substance, the domestic definition thus requires a fixed place of business (e.g. offices, production facilities etc.). The domestic definition largely corresponds to the one used by the OECD model convention. However, the OECD model convention provides for a number of exceptions which are not expressly contained in domestic law. Thus, the domestic PE definition seems broader than the one commonly used in international tax law. On the other hand, a fixed place of business is a constitutive requirement for a PE under domestic law with the consequence, that a dependent agent in the sense of the OECD model convention does not necessarily constitute a PE under Swiss domestic law.

Conversely, the income of foreign PE's of Swiss corporations is exempt from tax in Switzerland. Thus, in order to claim such exemption it is not required that a DTT provides protection. On this basis, a number of Swiss incorporated companies established PE's in offshore jurisdictions and allocated a portion of their income to the offshore PE. In a recent case, the Swiss Federal Court dealt with Swiss corporation with financing activities in an offshore jurisdiction (Finance Branch). The taxpayer claimed the foreign PE exemption for the income of the branch on the basis that it employed five persons (part-time) and maintained office premises offshore whereas no substance was maintained in Switzerland. Given that no DTT between Switzerland and the offshore jurisdiction is in place, the court decision was based merely on Swiss domestic law. In its decision, the Federal Court held that in the present case the activities carried out abroad were not sufficient to constitute a PE in that they did not contribute to the overall value creation of the group. This decision implies that although substance may be an important criterion in the recognition of PE's, increased attention must also be paid to functions carried out in the PE. Interestingly, the court also held that the requirements to recognize a foreign PE of a Swiss corporation are higher than the ones which lead to a PE of a foreign corporation in Switzerland.

Substance and the Location of the Effective Management

In contrast to the Withholding Tax Act, the Federal Income Tax Act only requires the place of management to be in Switzerland for a foreign company to become subject to (unlimited) tax in Switzerland – a business activity in Switzerland is not required. Thus, a foreign company may be deemed tax resident in Switzerland for income tax purposes but not for withholding tax purposes.

The definition of the place of effective management is, however, the same for income and withholding tax purposes. The relevant management activities are therefore the operational decisions relating to the actual business of the company, rather than the pure administrative tasks or the strategic oversight. Again, a substance over form approach is taken and the determination of the place of effective management is made according to qualitative criteria rather than a pure analysis of substance in one place or the other. The Swiss Federal Court recently ruled on the following case: An investment company registered offshore had own office premises and local staff employed offshore. Board meetings were held and formal decisions were taken offshore at the premises of the company. However, the offshore company was regularly advised by an investment advisor (related party) in Switzerland who provided investment research and recommendations. The court held on this basis that the day-to-day management effectively took place in Switzerland. In terms of the place of effective management, these activities prevail over the administrative and over the decisions of the board of directors. The court ruled that the offshore company was tax resident in Switzerland.

Conclusion

Substance is an important element to be considered in international tax planning involving Switzerland. It is, however, not the only element to be considered in international structures to avoid tax exposures or even tax leakage. Recently, qualitative elements such as beneficial ownership or assignment of functions have increased in their importance and it became significantly more difficult to make use of offshore jurisdictions in structures involving Swiss companies.

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6. United States of America (Brix+Partners LLC)

Apple, Amazon, Microsoft – The list of U.S. corporations with astoundingly low effective tax rates is not short and has raised a lot of criticism. The center of the concerns is that some taxpayers are able to artificially detach tax consequences from the underlying value-creating activity. However, as current as this topic is, the efforts to link a transaction's tax consequences to the real economic substance of that transaction have a long history.

The following statements are intended to exemplary introduce a few major rules and concepts surrounding the topic *substance*. Firstly, the national rules will be outlined, followed by a discussion of substance rules of prevailing importance in the international context.

Concepts

In the United States, the *economic substance doctrine*, unlike many other principles of tax law, was developed by courts as a common law principle. Economic substance is a common law doctrine that courts have developed and applied to deny the tax benefit of a transaction that complies with the literal requirements of the statute but lacks any practical economic significance apart from the tax benefit achieved.

As early as in *Gregory* vs. *Helvering* (239 U.S. 465 (1935)), a reorganization implemented for the sole reason of distributing funds to the shareholder in the form of tax beneficial capital gains instead of dividend distributions was denied by the United States Supreme Court. The taxpayer, Ms. Gregory, did not argue that the reorganization was a tax-driven transaction. However, she followed all the statutory steps and, therefore, felt entitled to the beneficial tax outcome. In the aftermath of this case, the economic *substance doctrine* developed through further cases. The main goal of the doctrine has been to disregard business transactions if they lack economic substance or a business purpose.

In the year 2010, the economic substance doctrine was codified.

Interestingly, the statute does not define when a transaction has economic substance, but rather defines, what the key elements of a substantial economic transaction are:

- The transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position; and
- The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

This extremely broad definition of a transaction having economic substance grants the tax authorities extensive rights to undo completed transactions.

Controlled Foreign Corporations (CFC) and Passive Foreign Investment Companies (PFIC)

Similar to the German rules stipulated in the Foreign Transaction Act (Außensteuergesetz), where a set of rules attempts to avoid profit shifting to low-taxing countries, the United States has implemented a pair of rules that tries to prevent taxpayers from artificially benefitting from differing tax regimes: The rules for *controlled foreign corporations* (CFC) and the rules for *passive foreign investment companies* (PFIC).

A foreign corporation is a CFC if more than 50% of its total voting power or value is owned by U.S. shareholders. A U.S. shareholder is any U.S. person (including entities) that owns directly or indirectly 10% or more of the total combined voting power of the foreign corporation. In case of a CFC, the CFC rules provide that certain types of income of CFCs, though undistributed, must be included in the gross income of the U.S. shareholder in the year the income is earned by the CFC.

Simultaneously, taxpayers have to be aware of the rules for *passive foreign investment companies* (PFIC). A PFIC is any foreign corporation who has:

- At least 75 per cent of its gross income from passive investments; or
- At least 50 per cent of its assets produce passive income.

A special tax regime applies when a U.S. shareholder receives a distribution from a corporation qualifying as a PFIC. PFIC distributions fall into two categories: "excess" and "non-excess" distributions. An excess distribution is the PFIC distribution that exceeds 125 per cent of the average distributions made to the shareholder with respect to the shareholder's shares within the three preceding years or if held for less than three years, the shareholder's holding period. The portion of the excess distribution to be allocated to the prior years in the taxpayer's holding period is not included in the taxpayer's current income. Rather, this portion is subject to a special "deferred" tax that the taxpayer must add to his tax that is otherwise due. In addition, interest has to be computed on the deferred tax amounts.

If a foreign corporation qualifies as both a CFC and a PFIC, the CFC rules prevail.

In practice, the combination of CFC and PFIC rules prevents lots of artificial structures. However, many economically substantial structures are effected by this set of rules as well. Therefore, thorough planning is crucial for U.S. outbound transactions.

Limitation of Benefit Clauses (LoB)

All U.S. tax treaties entail the so-called *limitation of benefits clause* (LoB). Applying the following tests, treaty shopping is supposed to be prevented (Art. 28 of the U.S./German treaty):

- Publicly traded test;
- Subsidiary of a publicly traded company;
- Ownership/base erosion test;

- Derivative test;
- Active trade or business test.

These well-established tests do prevent treaty shopping to a certain degree. However, the LoB, naturally, cannot prevent all artificial tax structures. By the same token, non-artificial tax structures could potentially fail the LoB tests. For both scenarios, the unfair restriction of treaty benefits and the unfair grant of treaty benefits, there are new developments.

For instance, in Art. 28 par. 7 of the U.S./German tax treaty, the taxpayer has the right to have the competent tax authorities determine, whether or not treaty benefits should be granted despite failing all other LoB tests. In Revenue Procedure 2015-40, the taxpayer must be able to show a substantial non-tax nexus to the treaty country, and that, if benefits are granted, neither the applicant nor its indirect owners will use the treaty in a manner inconsistent with its purpose.

Conversely, the U.S. Treasury has recently proposed revisions to the U.S. Model Income Tax Convention on 20 May 2015. Amongst other propositions, the U.S. Treasury proposes to deny treaty benefits for interest, royalties, or other income that benefit from a "special" tax regime in the recipient's country of residence. Under the proposal, a special tax regime would be defined as any legislation, regulation, or administrative practice that provides a preferential effective rate of tax to the tested income. A preferential tax rate has been proposed to be a rate below 15 per cent.

The change to the competent authority procedures as well as the proposed changes to the U.S. Model Income Tax Convention embody the first impacts resulting from the BEPS initiative in the United States. With respect to the proposed changes to the Model Convention, it yet remains to be seen to what extent these changes will be implemented and how the enhanced substance rules will be treated in future ratification procedures.

Conclusion

The doctrine of economic substance is very well-developed in U.S. law. Because of the increasing use of formalistic legal structures by multinational businesses to artificially reduce their global tax burdens, there has been a renewed emphasis by the U.S. and the other OECD member states on applying that doctrine to international transactions. The BEPS project is a dramatic example of this new emphasis.

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III. Other selected issues

1. China: Indirect property transfers by non-resident enterprises

The China State Administration of Taxation (SAT) is continuing to strengthen the PRC Enterprise Income Tax (EIT) on indirect property transfers by non-resident enterprises. This heightened control over tax exposure on such transfers in China makes it important for investors in such enterprises to ensure tax compliance and to structure their transactions accordingly.

Circular Guoshuihan [2009] No. 698 ("**Circular 698**") issued by State Administration of Tax ("**SAT**") in 2009 provided that a transfer of equity by an offshore company which indirectly holds equity in a China tax resident enterprise ("**TRE**") is subject to Chinese enterprise income tax ("**EIT**"), if the arrangement is deemed as an abusive use of company structure but without justifiable purposes. Ever since Circular 698 became effective, SAT was striving to improve taxation on such offshore indirect equity transfers.

Extended Scope of Offshore Indirect Transfers

Then, in 2015, SAT issued the SAT Announcement [2015] No. 7 ("**Announcement No. 7**"), namely the "Announcement of the State Administration of Taxation on Several Issues Concerning the Enterprise Income Tax on Indirect Property Transfer by Non-Resident Enterprises", to further strengthen the control over offshore indirect equity transfers.

Announcement No. 7 extends the regime on taxation for offshore indirect transfers of Chinese Taxable Properties (as defined below) compared to Circular 698. It is hence clarified that not only offshore indirect transfers of equity may be taxed, but also transfers of real estate and equity investment assets in TREs in China (collectively referred to as "**Chinese Taxable Properties**") may trigger a tax exposure in China if Chinese tax authorities deem such transactions are conducted without any justifiable business purposes.

Justifiable Business Purposes

Further, Announcement No. 7 offers clearer guidance compared to Circular 698 on how to assess "justifiable business purposes". Announcement No. 7 outlines eight different aspects which shall be considered by Chinese tax authorities to assess if a transfer transaction is to be deemed with or without justifiable business purposes. These eight aspects comprise:

- whether the main value of the equity of the enterprises abroad is derived (in-)directly from Chinese Taxable Properties;
- whether the assets of the enterprises abroad are mainly composed of investment (in-)directly made in PRC territory or whether the income of enterprises abroad is derived mainly and (in-directly) derived from PRC territory;
- whether the functions actually performed and the risks undertaken by the enterprises abroad and their subordinate enterprises directly or indirectly holding Chinese Taxable Properties can prove that the enterprise's structure has economic substance;
- who are the shareholders and what is the business mode of the enterprises abroad and for what time have the relevant organizational structures been in place;
- what taxes apply abroad to the indirect transfer of Chinese Taxable Properties;
- the substitutability between the transaction of indirect investment in and indirect transfer of Chinese Taxable Properties and the transaction of direct investment in and direct transfer of Chinese Taxable Properties by an equity transferor;

- tax conventions/arrangements applicable in China to the income from indirect transfers of Chinese Taxable Properties;
- other relevant aspects.

Announcement No. 7 further stipulates four circumstances in which a transaction can be immediately deemed as having no justifiable commercial purposes, these circumstances are (known as the "Red Area"):

- at least 75 per cent of the equity of the enterprise abroad (i.e. outside China) is (in-)directly held by Chinese Taxable Properties;
- at least 90 per cent of the total assets (not including cash) of the enterprise abroad (i.e. outside China) are (in-)directly composed of investments in China at any time in the year before the indirect transfer of Chinese Taxable Properties, or at least 90 per cent of the income of the enterprise abroad (i.e. outside China) is (in-)directly derived from China in the year before the indirect transfer of Chinese Taxable Properties occurred;
- despite the enterprise abroad (i.e. outside China) and its subordinate enterprises directly or indirectly holding Chinese Taxable Properties having a registered seat in their country aboard in order to satisfy the organization form required by the local laws of the host country, the functions actually performed and the risks undertaken by such enterprises abroad are limited and insufficient to prove economic essence;
- the income tax payable abroad for the indirect transfer of Chinese Taxable Properties is lower than the possible tax liability in China as for the direct transfer of Chinese Taxable Properties.

Safe Harbors

Announcement No. 7 introduces "safe harbor" scenarios in that the offshore indirect transfer of Chinese Taxable Properties meeting the below criteria shall be deemed as having justifiable commercial purposes:

- The equity relationship of the parties involved in the transfer fulfills at least one of the following conditions:
    - the equity transferor (in-)directly owns at least 80 per cent of the equity in the target enterprise (equity transferee);
    - the equity transferee (in-)directly owns at least 80 per cent of the equity of the equity transferor;
    - at least 80 per cent of the equity of both equity transferor and equity transferee is owned by the same party.

      NOTE: If more than 50 per cent (not including 50 per cent) of the value of the equity of an enterprise abroad is (in-)directly composed of real estate in China, the 80 per cent-rates above shall be increased to 100 per cent. Also, the aforesaid indirectly held equity shall be calculated by multiplying the shareholding ratios of all enterprises in chain of shareholders.
- Chinese income tax applicable to a future indirect transfer after the current indirect transfer should not be less comparing to a similar transaction in case the current indirect transfer had not happened.
- The equity transferee pays the full equity transfer consideration by providing its own equity by providing equity in enterprises controlled by it (not including equity of stock-listed enterprises).

Withholding Agent

Announcement No. 7 finally also clarifies that the withholding agent in China for tax declaration for such offshore indirect transfers of Chinese Taxable Properties shall be the entity/individual having the immediate payment obligation to the transferor. If withholding agent fails to withhold the payable EIT, the tax authorities may investigate the liability of the withholding agent.

Conclusion

Announcement No. 7 does not provide any restriction on the transaction that falls into the "safe harbor" and hence the documentation shall be well reserved by the equity transfer parties to prove that the transaction falls into the "safe harbor" scenarios. Also, one shall try its best to avoid that the transaction will fall into the "Red Area" which will trigger the anti-tax avoidance investigation by Chinese tax authorities. If the transaction falls into neither the "safe harbor" nor the "Red Area", one shall self-assess if the transfer transaction is with justifiable business purposes based on the eight aspects mentioned above, or could consider to report to the competent Chinese tax authorities and ask for their advice if the decision cannot be made based on self-assessment.

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2. Germany: Foreign subsidiaries and domestic commercial criminal law

Commercial criminal law issues can also arise in Germany in connection with companies established under the law of a foreign country. The Federal Supreme Court had to deal with one such case in 2010 (Judgment of 13 April 2010, 5 StR 428/09).

The defendant in the case was the director of a company established under the laws of the British Virgin Islands. He was accused of making an unauthorized online transfer of money from the company's account to one that would benefit him from his home in Germany.

Prior to the allegation, 60 per cent of the company's revenue was secured in safe deposit boxes. Over time, the accused's partner had used several millions in cash to benefit himself. After making this discovery, the partner suggested that the accused "step down" in exchange for an appropriate sum. It was at this point that the accused decided to transfer the money from the company's account to one that would benefit him. The accused made the transfer from his home in Germany, so that the action which gave rise to the crime occurred in Germany.

The Federal Supreme Court had to decide whether these facts amounted to criminal embezzlement. It came to the following decision:

If the defendant is a director of a foreign company and is accused of transferring money from the company's account to an account for his own benefit while at home in Germany, and he does not have the authority to make such a transfer, the relationship between the

partners and the articles of association of the limited company must be acknowledged when considering a possible case of criminal embezzlement.

The so-called foundation theory, which was developed in civil law, also applies in criminal law. According to this theory, the legal capacity is to be assessed on the basis of the law of the country in which the foreign company is incorporated. In the case of a limited liability company established in another EU Member State, the foreign corporate law applies when determining the duties of directors within the meaning of section 266 first paragraph of the German Penal Code (StGB). The German corporate law does not apply.

In summary, from a criminal law perspective, in the case of a company established under foreign law, such as an English limited liability company, the corporate law rights and obligations of the persons acting on behalf of the company are to be considered in light of the laws of that foreign country. If those persons fail to act in compliance with the foreign laws, they may be liable under criminal law in Germany – even when any factual connection to Germany is tenuous.

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