The notion of economic substance

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Economic substance

“In line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction.

In this regard the parties’ conduct should generally be taken as the best evidence concerning the true allocation of risk”.

Paragraph 1.26
“However there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties’ characterisation of the transaction and recharacterise it in accordance with its substance."
Economic substance

An example of this circumstance would be an investment in an associated enterprise in the form of interest bearing debt when, at arm’s length, having regard to the economic circumstances of the borrowing company, the investment would not be expected to be structured in this way.

In this case it might be appropriate for a tax administration to characterise the investment in accordance with the economic substance with the result that the loan may be treated as a subscription of capital”.

Paragraph 1.37
Differences between 1.26 and 1.37

• The Note recognises there is a difference between making a comparability adjustment and not recognising the risk allocation in a controlled transaction

• The example in the Note aims to illustrate this
Differences between 1.26 and 1.37

- Manufacturer
  - Country A

- Related Distributor
  - Country B

- Unrelated Distributor
  - Country B

- Unrelated Distributor
  - Country B
Differences between 1.26 and 1.37

• Manufacturer – Country A – has related and unrelated distributors in Country B

• Both in terms of the contractual arrangements and the actual conduct of the parties the manufacturer bears the excess inventory risk in its controlled transactions

• If there is reliable evidence from comparable uncontrolled transactions supporting this risk allocation there would be no reason to challenge the allocation.
Differences between 1.26 and 1.37

• If the risk allocation differs from the allocation with the unrelated distributors

• and there is no reliable evidence of comparable uncontrolled transactions where the excess inventory risk is assumed by the manufacturer

• it is necessary to consider whether the contractual risk allocation in the controlled transaction would have been agreed at arm’s length.
Differences between 1.26 and 1.37

• One factor that can assist in that determination is an examination of which party(ies) has(ve) greater control over the excess inventory risk.

• Another factor may be the party’s anticipated financial capacity to bear that risk.

• If the distributor has relatively more control over the excess inventory risk the tax administration may conclude that at arm’s length a manufacturer would not agree to take on substantial inventory risk.
Differences between 1.26 and 1.37

- In such circumstances the tax administration may re-assign the consequences from the risk allocation to the related distributor following the guidance of Paras 1.25 – 1.27

- (For example by challenging the manufacturer’s obligation to repurchase unsold inventory at full price).

- If the allocation of that risk is one of the comparability factors affecting the controlled transaction under examination.
Differences between 1.26 and 1.37

• There can also be cases where risk allocation is a core element of the transaction and where a dispute on the allocation of risk between the parties would amount to a dispute about the fundamental nature of the transaction.

• Such cases would fall under the guidance of Paras 1.36 to 1.41.
Suggestions for discussion

• What is the meaning of economic substance in the context of Para 1.26 and 1.37

• Would it be useful to include a discussion of the meaning of economic substance in the guidance that is being developed

• If so what should be the main features of that discussion