The notion of “economic substance”

Andreas Bullen (PhD Research Fellow)
Department of Public and International Law
Faculty of Law
University of Oslo
(1) Economic substance – in general

- “Economic substance” is merely a label with no clearly defined meaning
  - Significant risk of different interpretations
- It cannot automatically be assumed that this label refers to the same phenomenon in different parts of the Guidelines
- As opposed to the draft version of TPG 1.37, the draft version of TPG 1.26 (as well as that of 1.27) did not use the phrase “economic substance”
- The inclusion of the phrase “economic substance” in TPG 1.26 → more likely to confuse than to clarify
(2) Economic substance – in general

• The OECD Guidelines’ notion of “economic substance” → two distinct prongs:
  – The factual substance prong
    • “Economic substance” → expressed through the associated enterprises’ actual conduct
  – The arm’s-length prong
    • “Economic substance” → expressed through independent enterprises’ expected behavior
(3) The factual-substance prong (TPG 1.26, 1.28-1.29)

- TPG 1.26: The "economic substance" = the risk allocation evidenced by the associated enterprises’ actual conduct:

  "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"

- TPG Draft para 43:
  - "In line with the discussion below in relation to contractual terms, the parties’ conduct should generally be taken as the best evidence concerning the true allocation of risk"
    » No reference to “economic substance”
(4) The factual-substance prong (TPG 1.26, 1.29)

- TPG 1.29:
  - “important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction”.
(5) The factual-substance prong (TPG 1.26, 1.29)

• The factual-substance prong and the arm’s length principle:
  – True: the reason why the enterprises do not conform to their contract may be that they are associated
  – However: Discrepancies between written terms and actual conduct are not dealt with through application of the arm’s-length test
    • Thus: The associated enterprises are not deemed to have conformed to their written terms based on the theory that independent parties normally do so
  – Rather: the actual conduct are deemed to express the “conditions (...) made or imposed” between the associated enterprises” (TPG 1.26 and 1.29)
(6) The arm’s-length prong (TPG 1.27, 1.37)

- TPG 1.27 and 1.37: “Economic substance” = the transaction/risk-allocation independent enterprises are expected to adopt
  - TPG 1.27:
    - “An additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control”
(7) The arm’s-length prong (TPG 1.27, 1.37)

- TPG 1.37:
  - “An example of (...) [the first] circumstance [referred to in TPG 1.37] 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” (TPG 1.37)
  - In both circumstances referred to in TPG 1.37 “Article 9 would (...) allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length” (TPG 1.38)
    - What is the difference between the “economic” and “commercial” reality of parties dealing at arm’s length? The same?
(8) Reasons why the two prongs should be distinguished from each other

(1) Different points of reference for determining whether an adjustment is authorized and how an adjustment should be undertaken:

• The factual-substance prong: The associated enterprises’ own actual conduct
• The arm’s-length prong: The expected behavior of independent enterprises
• The prongs may, thus, dictate different adjustments
(9) Reasons why the two prongs should be distinguished from each other

(2) Adjustments based on the factual-substance prong → both the purported transaction and the transaction deduced from the associated enterprises’ actual conduct may satisfy the arm’s length principle

- E.g. in the Example provided by TPG 1.26:
  - “If, for example, a manufacturer sells property to a related distributor in another country and the distributor is claimed to assume all exchange rate risks, but the transfer price appears in fact to be adjusted so as to insulate the distributor from the effects of exchange rate movements, then the tax administrations may wish to challenge the purported allocation of exchange rate risk”
(10) Reasons why the two prongs should be distinguished from each other

- If both the manufacturer and the distributor have financial capacity to bear the currency exchange risk → both allocation of the risk to the distributor and allocation of the risk to the manufacturer would be arm’s length

- The point made by the example is thus:
  - Not that: unrelated enterprises would not have assigned the currency exchange risk to the distributor
    » The example simply does not address this issue
  - But rather that: the associated enterprise themselves have not actually – by way of actually conduct - assigned the currency exchange risk to the distributor
(11) Reasons why the two prongs should be distinguished from each other

(3) Different levels of difficulty in performing adjustments under the two prongs:
   – The factual-substance prong:
     • Point of reference for the adjustment: The associated enterprises’ own actual conduct
       – Moderate difficulties in establishing this conduct
       – The associated enterprises themselves normally have the power to provide the necessary evidence
(12) Reasons why the two prongs should be distinguished from each other

- The arm’s-length prong:
  - Point of reference for the adjustment: The expected behavior of independent enterprises
    - Often significant difficulties in establishing this expected behavior
      → Acknowledged by TPG 1.36 third sentence:
        » “Restructuring of legitimate business transactions would be a wholly arbitrary exercise the inequity of which could be compounded by double taxation created where the other tax administration does not share the same views as to how the transaction should be structured”
    - Normally not easier to establish for the associated enterprises than for the tax administration
Thank you!

andreas.bullen@jus.uio.no