

# ICC POLICY STATEMENT ON SUBSTANCE REQUIREMENTS FOR TRANSFER PRICING

## POLICY STATEMENT

Prepared by the ICC Commission on Taxation

## **ICC calls for a well-balanced application of existing economic substance requirements in tax and transfer pricing**

### **Introduction**

In the context of the latest international tax and transfer pricing development, namely “Base Erosion and Profit Shifting” or BEPS, the principle of economic substance has elicited some attention. The concept of economic substance serves as a key criterion for determining whether an economic activity is established only legally (for example a letterbox company) or whether there is personnel and an organizational structure (for example, a business operation including personnel and infrastructure). For example, a letterbox company without any personnel has generally no economic substance, but only a legal basis.

The challenge with any economic substance requirements is their factual nature and the wide leeway for varying interpretations of their content. This ICC statement therefore emphasizes the importance of applying the existing legislative framework on substance requirements in a uniform and consistent manner, to avoid double-taxation and obstacles to cross border trade and investment.

Economic substance is a doctrine in tax/transfer pricing law under which a transaction must have an economic purpose and not solely for the reduction of tax liability in order to be considered valid. This doctrine is used to determine whether tax/transfer pricing structures or strategies used are considered abusive. Economic substance in related party transactions does not necessary imply that the transaction would have been performed between independent parties, but that rationality behind the transaction, beyond the tax efficiency, exists.

The principle of "economic substance" or "economic activity" is relevant in various areas of national and international tax law and economic activities, such as rules for tax treaty entitlement, transfer pricing regulations, anti-treaty shopping rules, General Anti-Abuse Rule (GAAR) and value-added tax (VAT).

The absence of clear standards on how economic substance can be understood in the context of BEPS; different perspectives, compounded by a lack of experience due to limited guidance; as well as a potentially increasing number of additional sources will most likely create new conflicts in the near future with evident risks of uncertainty and interpretation.

### **Outline of problems and obstacles**

The OECD published, on 5 October 2015, final reports on fifteen BEPS actions. These reports include a number of areas, where the concept of economic substance will become a key consideration, i.e. in BEPS actions 6, 7, 8, 9 and 10.

The EU Commission published on 28 January 2016, a legally binding council directive on rules against tax avoidance practices. Whilst this directive directly refers to the BEPS actions and will prompt a regional discussion on the details of BEPS in Europe, potential risks exist for global inconsistencies.

*Definitions and standards are not in sync*

Potential risks and conflicts for multinationals arise from inconsistent definitions of the concept of economic substance relating to the deductibility of costs, the access to tax benefits, withholding taxes in areas of Corporate Income Tax (CIT), VAT and transfer pricing. Different perspectives need to be considered when looking at the economic substance, i.e. the perspective of the parent country state, the perspective of the source state and the perspective of any intermediary company state.

*Multiple number of different local substance requirements*

Various countries have established substance requirements in local tax law that are inadequately defined and are not consistent among themselves, i.e. in the Netherlands, Germany, China, Luxemburg and Russia. The implementation of the BEPS package will very likely extend this list comprehensively.

*Court cases*

Various courts (e.g. the European Court of Justice) have judged by considering the principle of economic substance as a key indicator in various underlying court cases.

*Example: New Chapter VI OECD TP Guidelines*

BEPS action 8 introduces a revised chapter VI of the OECD Transfer Pricing Guidelines. A key element is the principle of economic substance including various criteria for anchoring the ownership of intangibles. In this context "substance" is the umbrella term for people functions being performed, risks being taken and assets being used. Among others, the factors below need to be considered when analysing the economic substance for chapter VI purposes:

- Functions (Development/Enhancement/Maintenance/Protection/ Exploitation) including inherent overlaps;
- Risks (i.e. development, product obsolescence, infringement, product liability); and
- Control.

**ICC recommendations**

ICC calls for:

- A consistent, well-balanced and uniform application of existing definitions and standards on economic substance for tax and transfer pricing purposes to avoid misinterpretations and subsequent double taxation risks;
- The establishment of appropriate dispute resolution mechanisms; and
- Aligned and overarching application of existing principles on economic substance for CIT, VAT and transfer pricing.



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