

Article: The Case of Economic Substance

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EUROPEAN COURT OF JUSTICE CASE

The European Court of Justice in the case of Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd Vs Commissioners of Inland Revenue (C-196/04), has given useful guidance on the issue of real economic substance.

The case concerned the application of UK controlled foreign companies (CFC) legislation to two Irish subsidiaries of Cadbury Schweppes based in Dublin's International Financial Services Centre. Cadbury Schweppes did not dispute that the main reason for putting the structure in place in Ireland was to take advantage of the lower tax rates available there. The UK revenue authorities contended that the subsidiaries were merely a device to shift profits to a lower-tax jurisdiction, and their profits should be subject to UK tax.

Finding in favour of the taxpayer, the Court decided that rules such as those imposed by the UK are an illegal impediment to the freedom of establishment set out in the EC Treaty. Following the opinion of Advocate-General Léger, the Court confirmed that setting up a CFC to take advantage of a favourable tax regime does not constitute an abuse as long as the CFC operates from genuine offices and employs genuine staff in real activities.

According to the Court, anti-avoidance rules should apply only to 'wholly artificial arrangements intended to escape the national tax normally payable', and companies should be free to establish subsidiaries in a low-tax member state, as long as they carry on 'genuine economic activities' there. The Court accepted that the question of whether or not a subsidiary is genuinely established in a member state should be determined by reference to objective factors, and in particular to the extent to which the CFC physically exists in terms of premises, staff and equipment.

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Comment

The above case clearly illustrates that a subsidiary should have economic substance in terms of staff, premises and equipment and sufficient competence by its staff and board of directors in order to make necessary business decisions.

It should also provide a service that is genuinely required by the parent and not 'devoid of an economic purpose'. Otherwise, payment for such services could be viewed as an artificial transfer of profits from the parent company to the subsidiary.

The ECJ's decision therefore asserts international groups' right to use different jurisdictions to minimise their tax burden, and underlines the need to have a real economic presence in those jurisdictions in order to stay clear of any anti-avoidance traps.

REAL ECONOMIC SUBSTANCE

Whenever an international group establishes structures where there would be a holding company in a low tax jurisdiction and there would be subsidiary companies in the so called high tax countries, substance has become a crucial consideration at the holding company level.

Even in cases where a double tax treaty exists, current anti-abuse provisions require that the holding company is not simply interposed, just for the purposes of avoiding withholding tax in the countries where the subsidiaries are located.

In our experience and in accordance with the propositions made by the attorney general in the Cadbury Schweppes case, a holding company should operate from genuine offices, employ genuine staff in real activities.

Physical Premises

As international business comes under closer scrutiny, many tax authorities will not accept "brass name plate" structures as sufficient to qualify as bona fide operational entities. Centaur Trust, through our **"Idalion Business Centre"** can offer clients a wide range of physical office solutions, to meet even the most demanding requirements.

Incorporating the latest developments in security, IT and communications, the building is ideally designed to meet the needs of our clients well into the future.

The Idalion Business Centre is situated in over 4,200 sq. meters of landscaped gardens. In addition to the 1,000 sq. meters of office space, it also offers an in-house gym, a swimming pool, a business lounge café, and state of the art substance offices for our clients.

The Idalion Business Centre is a self-contained facility, offering our clients individual, fully-equipped offices, with full access to conference and secretarial services. Offices of various sizes are available, from cubicle offices up to fully equipped offices with staff. Clients are able to choose from the comprehensive services offered by the Idalion Business Centre, and when in Cyprus, will have full access to our IT, communications and conference facilities.

Staff

Whenever a Company needs to employ people, apart from choosing the appropriate staff to be employed, once the staff has been employed, companies also need to ensure compliance with an abundance of legislation (local employment laws, data processing and record keeping, social security and other payroll legislation as well as tax and pay-as-you-earn legislation). In an environment where regulations change continuously and scrutiny from the authorities is on the rise, it is becoming harder for companies to ensure that they are fully compliant.

Our worldwide network of experts can arrange to find and employ local staff in accordance with the needs and demands of our clients.

Furthermore we offer full support for handling your employment compliance worldwide in a coordinated way, provide advice on optimisation, and address related tax and immigration issues.

We offer full support for the proper legal and legislative documentation that is required for the employment of staff;

- Preparation of employment agreements in accordance with local rules
- Registration of the company as well as its staff with the relevant Income Tax and Social Insurance authorities
- Preparation of the company's monthly payroll and arranging the payment of monthly salaries, taxes and social insurance contributions
- Submission of the relevant monthly reports to the relevant authorities



REAL ACTIVITIES

With significant emphasis on the arguments presented in the opinion of the advocate general, the following factors are decisive in determining whether the company is involved in real economic operations in the country of residence.

- The general policy of the company should be formulated in the country of residence. The place of effective management is generally understood to be the place where the Head Office is: the Head Office in the sense of - not the registered office - but the central directing source. That is major/important decisions such as the provision of loan facilities, the purchase of a significant interest in other companies etc should be taken by the board in the country of residence.
- The appointed directors of the company should be fit to hold office or be employed in the administration of the Company's affairs. When appointing a board of directors, the individual members should be persons of high calibre, such as successful business men, Chartered and Certified accountants, lawyers, or persons with a relevant background in relation to the company's proposed activities. The directors should really have the knowledge and expertise to really understand and know the business activities of the company and they should actually be part of the strategic decision making process of the company. They should not just rubber stamp any decisions taken by the shareholders or their advisors. They should formulate and implement the strategy of the company.
- With regards to decision making at Directors' level, a minimum level of information should always be provided, that would enable the directors of a company to consider whether or not they should make a decision. It is also prudent to ensure that board minutes properly document the information the directors have used to consider and then make decisions.
- Related to the point above, care should be taken to ensure that the board meetings are properly documented, i.e. detailed notes taken, outlining the matters for consideration of the board, as well as the information provided in the board pack to enable them to make their decisions.
- Lastly but not least. The company should have a valid commercial reason for its existence. Even though this can at sometimes be a tax oriented reason, it should also have commercial benefits for setting a company in the particular jurisdiction and the decision to establish a Cyprus company should not be taken solely based on tax considerations.
- Consideration also needs to be given to whether the company's activities have sufficient economic substance, yielding a verifiable income, as well as looking at it's economic operations in order to fulfil the general requirements for setting up the company in the chosen jurisdiction.

CONCLUSION

Whenever an international group establishes structures where there would be a holding company in a low tax jurisdiction and there would be subsidiary companies in the so called high tax countries, substance has become a crucial consideration at the holding company level.

Even in cases where a double tax treaty exists, current anti-abuse provisions require that the holding company is not simply interposed, just for the purposes of avoiding withholding tax in the countries where the subsidiaries are located.

By following the few simple steps outlined above, the adverse tax consequences can be avoided. Our experience shows us that many companies seek tax advice prior to establishing an offshore business, however, few seek further advice on implementation and maintenance of these structures. It is often during the implementation phase and thereafter that mistakes are made.

At Centaur Trust our focus is on the effective implementation of international tax structures related to the use of Cyprus or other Companies as standalone vehicles or as part of an international tax structure. We work closely with all major legal, tax and accounting firms worldwide and based on our Total Quality Management philosophy we translate high quality advice into high quality solutions.

Thank you



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