The significance of substance in international tax law

In the PhD thesis there is analysed the term of substance from the perspective of international tax law. In three chapters substance is analysed in the context of tax residency, withholding tax and controlled foreign companies. There are presented also the results of research how substance may be defined. In principle it refers to people, assets and functions of an entity being a taxpayer. Often, also the business justification for running the entity is taken into account.

The research included both international and domestic regulations, laws, verdicts and doctrine. The aim was to cover the OECD (the Organisation of Economic Cooperation and Development) regulations, as also law and verdicts issued by the European Union institutions and selected national laws and verdicts (with special focus on Poland).

It is argued in the thesis that substance should be defined unanimously on the grounds of the three institutions. In order to achieve such approach, the OECD should issue clear guidelines in this respect, as also the European Union should adopt the substance directive in which substance is defined with quantitative measures.

Already in 2013 the OECD has initiated the BEPS (base erosion and profit shifting (BEPS) action followed with 15 reports. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity (substance deficiencies) or to erode tax bases through deductible payments such as interest or royalties. Although some of the schemes used are illegal, most are not. This undermines the fairness and integrity of tax systems because businesses that operate across borders can use BEPS to gain a competitive advantage over enterprises that operate at a domestic level. Moreover, when taxpayers see multinational corporations legally avoiding income tax, it undermines voluntary compliance by all taxpayers.

The thesis focuses on BEPS Action 3 (Strengthen CFC rules), Action 5 (Counter harmful tax practices more effectively, taking into account transparency and substance) and Action 6 (Prevent treaty abuse) as they in majority refer to the three tax institutions: of tax residency, withholding tax and controlled foreign companies.

On the level of the European Union the issue of substance has also led to proposing a new legislation. In December 2021 the European Commission presented a directive on preventing shell companies from misusing their structure for tax purposes ('Unshell'). The proposal introduced a 'filtering' system for EU company entities, which will have to pass a series of gateways, relating to income, staff and premises, to ensure there is sufficient 'substance' to the entity. Those entities that are deemed to be lacking substance are presumed to be 'shell companies' and, if they are unable to rebut this presumption through additional evidence regarding the commercial, non-tax rationale of the entity, they will lose any tax advantages granted through bilateral tax treaties or EU directives, thereby discouraging their use.

The issue of substance is related to the international tax law so the situation when a taxpayer is involved in at least two tax jurisdictions. Hence, the substance requirements should be unified at least on the regional level. Having particularities between countries, as also defining substance differently for various institutions makes it really hard for taxpayers to comply and to make wise tax planning.

Introducing into law the requirements of substance made the tax planning a more demanding and less-cost effective process, but it did not eliminate it on international level. Whereas from the perspective of tax authorities clear and quantitative laws would also ensure that the tax audits are conducted according to clear rules and their results are not later cancelled by courts.