CAPITAL ECONOMICS

Measuring economic substance in the EU

Key points

- The European Union wishes to unilaterally require 'economic substance' for entities transacting business in or through jurisdictions with no corporate taxation
- Requirements for physical substance are unprecedented and don't reflect the reality that value is created through non-physical infrastructure as well
- EU Member States themselves do not conform to a set of common criteria in relation to measures of economic substance for companies
- There is meaningful variation in residency and domiciliation requirements for companies between EU Member States

1. The European Union wishes to unilaterally set requirements related to addressing harmful tax practices to British-linked international finance centres

The European Union adopted a non-legislative 'Common List of Non-cooperative Jurisdictions for Tax Purposes' (dubbed its 'Blacklist') on 5th December 2017. Over 100 jurisdictions were reviewed for inclusion against three criteria: 1) tax transparency, 2) fair taxation, and 3) commitment to prevent Base Erosion and Profit Shifting (BEPS).

Criterion 2.2 blacklists jurisdictions that the EU deems to 'facilitate offshore structures or arrangements aimed at attracting profits that do not reflect real economic activity ('substance') in the jurisdiction'. A group of British-linked international finance centres (IFCSs) – including Bermuda, BVI, Cayman Islands, Guernsey, Isle of Man, and Jersey – have committed to address the EU's concerns about a supposed 'lack of economic substance'.

Official guidance notes from the EU have signalled that the OECD's work on harmful tax practices will serve as the starting point for defining substance. This guidance identifies a list of sectors that require substance asks for these sectors to maintain the following substance in their jurisdiction:

1. Premises with an adequate number of (qualified) employees in the jurisdiction;
2. Adequate level of annual expenditure in the jurisdiction; and
3. Key management and investment decisions made in the jurisdiction

2. Requirements for physical substance are unprecedented and don't reflect the reality that value is created through non-physical infrastructure as well

There is an international consensus that the right to impose taxes on profits is conferred on the jurisdiction where value is created. The rationale behind requiring 'substance' is that substance is the

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putative means by which companies create value. Physical substance – whether factories or offices – undoubtedly can create value, but it's not the only way that commercial endeavours create value.

Value is created in British-linked international finance centres through their ability to pool investment from around the world and facilitate cross-border investment. Their robust, secure, and reliable tax-neutral environment, with legal expertise rooted in English law, allows investments to be pooled from or invested into multiple jurisdictions. This diversifies investments, reduces risks, and meets the needs of global businesses.

By reducing risks and reducing the costs of international transactions, returns are increased, which creates extra profits for investors. This demonstrates that value creation can go far beyond the presence of large workforces and offices, and thus beyond the narrow definition used by the EU.

3. EU Member States themselves do not conform to a set of common criteria in relation to measures of economic substance for companies

There are a wide range of views on what economic substance means in practice. While the EU focuses on the physical, other factors might include corporate governance requirements, such as the preparation or audit of financial statements, and requirements related to local residency for directors, or auditors of companies.

We have investigated how EU Member States require a range of substance requirements for companies incorporated in their domestic jurisdictions, examining seventeen jurisdictions, including thirteen EU Member States. Residency and domiciliation requirements for companies vary dramatically across EU Member States (see Figure 1).

Figure 1: Residency/domiciliation requirements for a sample of EU Member States and selected countries for companies incorporated in each jurisdiction for a range of criteria

	Directors	Board meetings	A bank account	Financial statements	Records of corporate governance	Auditor	Physical premises or offices	Minimum number of employees	Minimum operating expenditure
Belgium	X	X	✓	✓	✓	X	X	X	X
Bulgaria	X	X	✓	✓	✓	✓	X	X	X
Cyprus	X	X	X	✓	✓	✓	X	X	X
Czech Republic	X	X	✓	✓	X	X	X	X	X
Hungary	X	X	✓	✓	✓	✓	✓	X	X
Ireland	X	X	X	X	✓	X	X	X	X
Italy	X	X	X	✓	✓	✓	X	X	X
Luxembourg	✓	✓	✓	✓	✓	✓	✓	X	X
Netherlands	✓	✓	✓	✓	✓	X	✓	X	X
Poland	X	X	X	✓	✓	✓	✓	X	X
Slovakia	X	X	✓	✓	X	X	X	X	X
Spain	X	X	✓	X	✓	X	✓	X	X
United Kingdom	X	X	X	X	X	X	X	X	X
Delaware	X	X	X	X	X	X	X	X	X
Dubai	X	X	X	X	✓	✓	✓	X	X
Hong Kong	X	X	X	✓	✓	✓	X	X	X
Singapore	✓	X	X	✓	✓	✓	X	X	X

Sources: Capital Economics. Note: A green '✓' mark denotes that companies incorporated in the jurisdiction are generally required to have the listed substance measures locally. A red 'X' indicates that companies incorporated in the jurisdiction are not required to have the listed substance measures locally.

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For example, companies incorporated in Luxembourg are required to have directors, board meetings, a bank account, financial statements and records of governance, an auditor, and physical premises in Luxembourg. By comparison, companies incorporated in the United Kingdom are not required to maintain any of these measures locally.

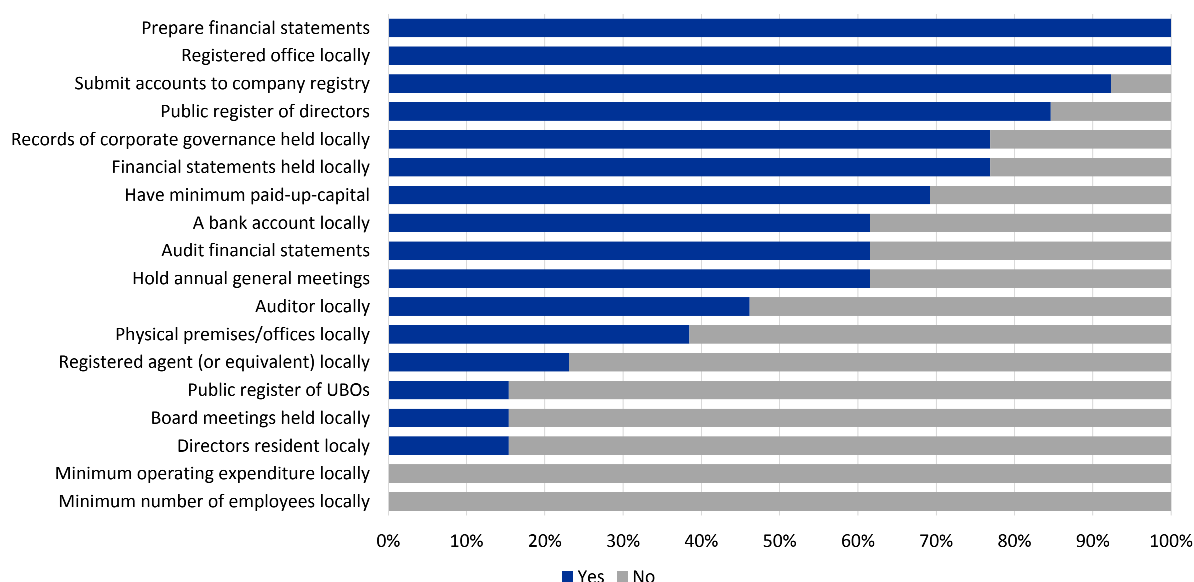
Of our sample of thirteen EU Member States, only Luxembourg and the Netherlands require directors domestically, while only Hungary, Poland, and Spain (in addition to Luxembourg and the Netherlands) require physical premises and offices locally. None of the EU Member States sampled requires companies to maintain a minimum number of employees or expenditure domestically.

4. Residency requirements for companies vary significantly between EU Member States

There is also variation between EU Member States in relation to measures of corporate governance and domiciliation for companies. While all EU Member States sampled require companies to prepare financial statements and maintain a local registered office, countries are less likely to require companies to have a local bank account, and hold annual general meetings or board meetings in their respective jurisdictions. Roughly half of EU Member States sampled require companies to have their financial statements audited, while just 15% require locally-resident company directors (see Figure 2).

Similarly, only 15% of EU Member States examined maintain publicly-accessible registers of companies' ultimate beneficial owners. The United Kingdom's recent legislation to unilaterally impose publicly-accessible registers on the Overseas Territories is unmatched elsewhere and does not reflect a standard adopted widely in the EU, let alone globally.

Figure 2: Share of a sample of EU Member States that have selected corporate governance and local residency and domiciliation measures



Sources: Capital Economics. Note: European Union countries include Belgium, Bulgaria, Cyprus, the Czech Republic, Hungary, Ireland, Italy, Luxembourg, the Netherlands, Poland, Slovakia, Spain, and the United Kingdom

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