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## “Substance” – a Singapore’s perspective

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Tang Siau Yan

## “Substance” – a Singapore’s perspective

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And

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17 April 2017

*One of the principles underpinning the OECD Base Erosion and Profit Shifting (“BEPS”) project is the concept of “substance”. Taxation is to be aligned with substance so that profits are being taxed in the location where value is created. However, what constitutes “substance” has not been clearly defined. This paper seeks to examine the concept of substance as applied in different contexts and attempts to put forth a notion of substance that is relevant to Singapore.*

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### Introduction

1. The Base Erosion and Profit Shifting (“BEPS”) project was conceived by the OECD in 2013 to tackle the issue of multinational corporations (“MNCs”) exploiting mismatches in tax rules across jurisdictions to reduce their taxable profits or artificially shifting profits to locations where they enjoy more favourable tax treatment<sup>2</sup>. The project consists of 15 action plans and is based broadly on 3 principles – coherence, substance and transparency<sup>3</sup>:
  - a) Coherence - domestic tax rules should be aligned to prevent mismatches that result in double non-taxation or excessive deduction of expenses.
  - b) Substance – taxing rights should be given to the locations where substantive value-creating activities are located.
  - c) Transparency - there should be greater disclosure of information between taxpayers and tax administrators, and among tax administrators.
2. Fundamentally, if the precept is that taxation should be a consequence of the economic substance of transactions, then the other 2 principles underpinning the BEPS Action Plan, i.e. coherence and transparency, serve to align taxation rules to achieve this outcome. From this perspective, substance is the key principle for a rational system of international taxation. Indeed, the concept of substance permeates the various action plans, particularly those relating to the preferential tax regimes (i.e. use of incentive), the prevention of treaty abuses and transfer pricing.
3. **Preferential regimes.** Work concerning preferential regimes started in the 1990s with the publication of an OECD report titled “Harmful Tax Competition – an emerging global issue” in 1998. The report focuses on preferential regimes that offer no tax or low tax rate for geographically mobile activities, for example, financial services and the use of intangibles<sup>4</sup>. BEPS

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<sup>2</sup> OECD, 2013, Action plan on base erosion and profit shifting, retrieved from <http://www.oecd.org/ctp/BEPSActionPlan.pdf> (accessed on 5 July 2016)

<sup>3</sup> OECD, 2013, Action plan on base erosion and profit shifting, retrieved from <http://www.oecd.org/ctp/BEPSActionPlan.pdf> (accessed on 5 July 2016)

<sup>4</sup> OECD, 1998, Harmful Tax Competition – an emerging global issue, retrieved from <http://www.oecd.org/tax/transparency/44430243.pdf> (accessed on 7 July 2016).

ACTION 5 “Countering harmful tax practices more effectively, taking into account transparency and substance” is in some ways, a continuation of that work. BEPS Action 5 concerns the use of preferential tax regime for base erosion and profit shifting activities. The mischiefs it is trying to address are artificial profit shifting and a lack of transparency with regard to certain preferential regimes<sup>5</sup>. BEPS Action 5 requires substantive activity for any preferential regime, and that taxation is aligned with substance, so that profits are being taxed in the location where value is created<sup>6</sup>. Consequently, there must be a demonstrated link between the core activities performed and the income qualifying for the concessionary tax treatment under the preferential tax regime<sup>7</sup>. To improve transparency, OECD has proposed to put in place a system of exchange of information in respect of rulings relating to preferential tax regimes.

4. **Treaty abuses.** There were concerns that MNCs were engaging in treaty shopping to minimise their tax liabilities. In addition, some MNCs were seen to be artificial breaking up their operations into multiple entities operating in different jurisdictions and being able to avoid tax by not being regarded as having a permanent establishment (“PE”) in these locations<sup>8</sup>. BEPS Action 6 “Prevent treaty abuse” and BEPS Action 7 “Prevent the artificial avoidance of PE status” thus look into tightening treaty provisions to prevent the granting of treaty benefits in certain situations. The recommendations under BEPS Actions 6 and 7 are mostly in the form of specific treaty rules that would provide new or revised objective thresholds for entitlement to treaty benefits or source taxation of business profits respectively, and not, for instance, some general rule to disregard legal arrangements in favour of some notion of economic substance. This is understandable since there would be a need to reduce ambiguity in the application of a treaty. Nevertheless, the underlying concerns reflected by BEPS Actions 6 and 7 are with artificial arrangements that seek to exploit existing treaty rules. While the response is to recalibrate such objective treaty rules, the underlying problem is the ability of abusive taxpayers to put in place of legal arrangements that are perceived to be artificial in relation to the economic realities of those arrangements.
5. **Transfer pricing.** Transfer pricing is perceived as an area where MNCs could manipulate legal arrangements to achieve favourable tax outcomes. Transfer pricing rules, based on the arm’s length principle, serve to allocate the profits of an MNC among the jurisdictions in which it operates. In some cases, particularly where use of intangibles or mobile assets is concerned, the OECD is of the view that the existing rules may have been misapplied to shift income to low-tax jurisdictions<sup>9</sup>. This could happen when the location where the income is booked is separated from the location where the income-generating activities are performed. This is more likely to occur for transactions between related parties. Transfer pricing rules have always sought to align transfer prices with the economic substance of transactions and are perhaps emblematic of the difficulties and subjectivity involved in doing so. Due perhaps to the scope for contention and the sense that multinational enterprises have successfully exploited the subjectivity of such rules, the re-examination of transfer pricing rules was an important aspect of the BEPS project.

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<sup>5</sup> OECD, 2015, Countering Harmful Tax Practice More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report, retrieve from <http://www.oecd.org/tax/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report-9789264241190-en.htm> (accessed on 30 Jun 2016)

<sup>6</sup> OECD, 2015, Countering Harmful Tax Practice More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report, retrieve from <http://www.oecd.org/tax/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report-9789264241190-en.htm> (accessed on 30 Jun 2016)

<sup>7</sup> OECD, 2015, Countering Harmful Tax Practice More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report, retrieve from <http://www.oecd.org/tax/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-action-5-2015-final-report-9789264241190-en.htm> (accessed on 30 Jun 2016)

<sup>8</sup> OECD, 2013, Action plan on base erosion and profit shifting, retrieved from <http://www.oecd.org/ctp/BEPSActionPlan.pdf> (accessed on 5 July 2016)

<sup>9</sup> OECD, 2013, Action plan on base erosion and profit shifting, retrieved from <http://www.oecd.org/ctp/BEPSActionPlan.pdf> (accessed on 5 July 2016)

To ensure that transfer pricing outcomes are in line with value creation, BEPS Actions 8, 9 and 10 studied and recommended rules to inhibit the artificial shifting of profits among group entities using transfer pricing rules. Action 8 focuses on rules governing the transfer of intangibles; Action 9 targets the transfer of risks among or the allocation of capital to entities within the group; and Action 10 concerns other transactions that seemingly pose high-risk of profit shifting, such as the use of management fees or head office expenses to erode the tax base. Although the recommendations arising from BEPS Actions 8, 9 and 10 do not fundamentally change existing transfer pricing principles, there is now clearer acknowledgement that some legal arrangements should not be recognised for transfer pricing purposes if they do not possess “the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances”<sup>10</sup>.

6. As explained, underpinning the above is the principle that the tax outcome should not be divorced from the substance of the transaction. Profits should be taxed where the economic activities generating the profits are conducted and aligned to the location where value is created. However, what constitutes “substance” has not been clearly expressed in the BEPS reports. In this regard, it is important for us to articulate a concept of substance this is relevant for Singapore’s purposes. This forms the basis of our evaluation as to whether our domestic tax rules are aligned to the international tax principles, and whether the companies operating in Singapore could withstand scrutiny in light of the substance requirement found under the various international tax rules.
7. This paper examines the concept of substance as applied in both tax and non-tax contexts. These include how substance is applied in domestic tax concepts concerning residence and permanent establishment, how it is applied in anti-avoidance rules, in treaty provisions and transfer pricing rules, and how it is featured in accounting and economic concepts. With the understanding, the paper proposes a set of indicators that could be used to measure the extent of existence of substance in a business or corporate structure.

### **What is “substance”?**

#### **(A) Concept of substance in residence test**

8. Tax residence establishes the nexus between a taxable person and a tax jurisdiction, and confers a right on the jurisdiction to impose tax on the person<sup>11</sup>. There are primarily two tests of residence: the incorporation test which looks at the place of incorporation and the control and management test which determines place of residence based on whether central management and control actually abides<sup>12</sup>. For this purpose, central management and control is assumed to be situated in the place where the board of directors exercises the power and authority vested in it by the Memorandum and Articles of Association of the Company. This refers to that the highest level of control, where strategic decisions are made. The test is however premised on a particular view of corporate governance that existed in simpler times, and may be argued to be rather antiquated in view of modern multinational corporate governance models. For example, it is highly questionable in a publicly listed company with a US or UK styled model of corporate governance whether it is the board of directors that makes the key decisions concerning the company’s business. Realistically, the board would make decisions based on the

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<sup>10</sup> Proposed paragraph 1.123 of the OECD Transfer Pricing Guidelines, as recommended under the OECD report *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – 2015 Final Reports*.

<sup>11</sup> Axel Smits and Isabel Verlinden, 2012, *Substance 2.0 - Aligning international tax planning with today’s business realities*, PricewaterhouseCoopers

<sup>12</sup> per Lord Loreburn, *De Beers Consolidated Mines v. Howe Ltd (Surveyor of Taxes)* (1906) 5 TC 198

recommendations of the company's executives who would be more aware of the actual circumstances of the company's business and finances. Furthermore, in a multinational corporate structure, the directors of a foreign subsidiary may be nominees or may have no independence from group strategies and policies - does it then follow that the subsidiary must be resident in the jurisdiction of the group headquarters?

9. The incorporation test is simple to administer and provides certainty. However, it can be easily manipulated and opens up opportunities for tax abuse. For example, the Apple group was able to exploit the differences in the US and Ireland corporate residence tests such that its Irish subsidiaries claimed tax residence nowhere<sup>13</sup>. Consequently, their incomes were taxed nowhere.
10. While the control and management test may seem to sit better with the concept of substance, as explained, it also lacks a satisfactory logical basis (at least when it is tied solely to the board of directors of the company). A company engaged in real activity generally has at least three levels of management: shop-floor or frontline management; day-to-day operations; and senior management<sup>14</sup>. A control and management test that takes into account the various levels of management of a company may be a better indicator of genuine economic connection with a jurisdiction, upon which the taxing right of that jurisdiction could be established<sup>15</sup>.

(B) Concept of substance in the tax treatment for hybrid financial instruments

11. Hybrid financial instrument refers to a financial instrument that has both debt and equity features. The issue posed by hybrid financial instrument is in its classification, which in turn determines the nature of the distribution from the instrument, i.e. whether it is dividend or interest. Due to the differing tax treatment for dividend and interest, there is a need to provide certainty on the classification rules for hybrid financial instruments.
12. For this reason, IRAS has published an e-Tax guide titled "Income Tax Treatment of Hybrid Instruments". It is stated in the guide that, in determining the characterisation of a hybrid instrument such as redeemable preference shares, the Comptroller of Income Tax takes the approach that the characterisation is first determined based on its legal form. This involves an examination of the legal rights and obligations created by the instrument. However, where the legal form of a hybrid instrument is not indicative of or do not reflect the economic obligations and rights, the characterisation of the hybrid instrument would be determined based on facts and circumstances<sup>16</sup>. In this regard, the analysis is first a factual and legal one. The notion of substance will then be applied to determine the degree of congruence between the legal form and the reality (i.e. the substance) the legal form purports to represent. But, what is the "reality"?

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<sup>13</sup> Sheppard L., 28 May 2013, How Does Apple Avoid Taxes, *Forbes*, retrieved from <http://www.forbes.com/sites/leesheppard/2013/05/28/how-does-apple-avoid-taxes/> (accessed on 7 July 2016).

<sup>14</sup> Axel Smits and Isabel Verlinden, 2012, *Substance 2.0 - Aligning international tax planning with today's business realities*, PricewaterhouseCoopers

<sup>15</sup> This would be more relevant in a worldwide taxation system where residents are taxable on their worldwide income. It is less relevant in a territorial taxation system where there is no differentiation in the taxation basis for residents and non-residents.

<sup>16</sup> IRAS, 19 May 2014, Income Tax Treatment of Hybrid Instruments, retrieved from [https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax\\_Guides/etaxguide\\_CIT\\_Income%20Tax%20treatment%20of%20Hybrid%20Instruments\\_2014-05-19.pdf](https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguide_CIT_Income%20Tax%20treatment%20of%20Hybrid%20Instruments_2014-05-19.pdf) (accessed on 27 June 2016)

13. Perhaps, guidance can be inferred from the bifurcation approach that some other countries adopt to address the hybridity of certain financial instruments. Bifurcation involves the division of a financial instrument into its embedded debt and equity element respectively<sup>17</sup>. Instead of taking a cubby-hole approach and forcing an instrument into either the debt or equity classification, the bifurcation approach looks at the expected and unexpected gains and losses associated with the basic building blocks that made up the financial instrument<sup>18</sup>. It segregates the expected time-value return in an instrument from the unexpected gain or loss in value of the instrument, and applies the relevant tax treatment to the two parts respectively. By doing so, taxation is better aligned with the economic consequences that are brought about by the financial instrument. In this way, the reality or substance of a transaction is to be found in its “economic equivalence”.
14. While an approach based on economic equivalence would be theoretically more coherent and consistent, IRAS’ approach reflects an attitude of administrative pragmatism to take the legal arrangement as the default position. It would be for a party (more likely IRAS since the taxpayer has chosen the particular legal arrangement) to assert that the economic substance of the arrangement is something different – this improves predictability and certainty of tax outcomes for taxpayers. In contrast, a bifurcation approach would involve the taxpayer in subjective and possibly needless financial and economic analyses of every financial instrument.

(C) Concept of substance as applied in anti-avoidance cases

15. The notion of “substance over form”, i.e. looking at the economic realities instead of legal relationships or arrangements, is very relevant in the area of addressing tax avoidance.
16. Tax is essentially a creature of statute. Traditionally, the tax courts in the United Kingdom (“UK”) had adopted a literal approach to interpreting tax law. In fact, a taxpayer’s right to arrange his affairs in such a manner to minimise his tax liability was endorsed by the courts<sup>19</sup>. In *IRC v Duke of Westminster* [1936] AC 1<sup>20</sup>, the Court also opined that it could not ignore the legal position and regard the substance of the matter. In their view, the substance was “that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles”. As such, even though the arrangement was clearly intended to result in a tax benefit for the taxpayer, the taxpayer is entitled to do so.
17. However, such a literal interpretation of the law has facilitated the use of convoluted and highly artificial tax planning schemes. As such, beginning with *WT Ramsay Ltd v IRC* [1981] All ER 865, the House of Lords began to address tax avoidance structures. Initially, the approach was more circumscribed and appeared to be directed at arrangements with self-cancelling steps (as in *Ramsay*), but later this was clarified to be an application of a purposive interpretation of the law<sup>21</sup>. There was a paradigm shift in the view the courts viewed tax arrangements - the courts

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<sup>17</sup> Tim Edgar, 2000, Chapter 6 Bifurcation and the Taxation of Hybrid Instruments, *The Income Tax Treatment of Financial Instruments: Theory and Practice*, Canadian Tax Paper No.105, Canadian Tax Foundation, pp. 243 -311

<sup>18</sup> Tim Edgar, 2000, Chapter 6 Bifurcation and the Taxation of Hybrid Instruments, *The Income Tax Treatment of Financial Instruments: Theory and Practice*, Canadian Tax Paper No.105, Canadian Tax Foundation, pp. 243 -311

<sup>19</sup> Per Lord President Clyde in *Ayrshire Pullman Motor Services v IRC* (1929) 14 TC 754

<sup>20</sup> In this case, the Duke executed deeds with persons then employed by him. Under the deeds, they will receive weekly sums for a period of seven years or the joint lives of the parties. Previously, these recipients were receiving fixed wages. After the execution of the deeds, they remained employed by the Duke and the amount payable to them under the deeds will be exactly the same as the wages they received before the deeds. The issue was whether the payments made under the deeds were remuneration for services or annual payments. If the sums were annual payments and not remuneration for services, the Duke would be allowed a deduction against his liability to surtax. The Lords held that the payments were not remuneration for services.

<sup>21</sup> *Barclays Mercantile Business Finance Ltd v Mawson* [2005] 1 All ER 97

began to look at the substance of an arrangement as a whole rather than just the words and deeds of the individual transactions forming part of the arrangement. In applying the purposive interpretation, the courts also considered the intent of the Parliament when the rules were legislated. Nevertheless, the application of a purposive interpretation of the law has proven deficient in tackling arrangements that are not illegal, but often convoluted or artificial.

18. To further rein in the unacceptable tax planning activities, the UK introduced its first general anti-abuse rule (“GAAR”) in 2013. It is meant to be a narrowly focused anti-abuse rule targeting abusive tax avoidance schemes. It rejects the approach taken by the courts in a past that taxpayers are entitled to reduce their tax bills by whatever lawful means. Rather, the enjoyment of a tax benefit needs to be within the boundaries contemplated by the Parliament, and the obtaining of a tax advantage should not have been the main purpose, or one of the main purposes, for putting in place the relevant arrangements<sup>22</sup>. To establish whether the obtaining of a tax advantage was the main purpose or one of the main purposes, it is to be proven that the transaction which would otherwise have occurred has been redesigned, or has been entered into under different terms and conditions, in order to change appreciably the tax result that would otherwise have resulted, and where that favourable tax outcome is itself a substantial objective<sup>23</sup>. In this way, the notion of “substance” encompasses not only the economic effect of the transaction, but also the facts and circumstances surrounding the conduct of the transaction.
19. While there is no GAAR per se in the US, the US judiciary has created a number of anti-avoidance doctrines: (a) the “business purpose” doctrine, which examines the purpose of a transaction; (b) the “economic substance” doctrine, which looks at a taxpayer’s economic position; (c) the “step transaction” doctrine, which disregards interconnected steps that have no significance for tax purposes by consolidating these into a single transaction; and (d) the “substance-over-form” doctrine, which disregards the legal form of a transaction in favour of its underlying economic substance.
20. The US economic substance doctrine is legislated under section 7701(o) of the Internal Revenue Code. Under this section, the transaction shall be treated as having economic substance only if “(a) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (b) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction”. The first limb requires an objective analysis of the taxpayer’s economic position before and after the transaction, whilst the second limb focuses on the motive of the taxpayer for entering into the transaction.
21. It is noted that the “meaningful” standard differs from the “possibility of profit” test. The test recognises that businesses may undertake transactions that do not produce an identifiable income stream in isolation, for example, transactions relating to corporate restructuring<sup>24</sup>. In addition, it is not necessary for the taxpayer to show the pre-tax profit of a transaction to demonstrate its substance. However, where the potential for profit is relied upon by the taxpayer as a measure of substance, the taxpayer has to show that the expected pre-tax return is significant compared to the expected tax benefits.<sup>25</sup>

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<sup>22</sup> HMRC, Tax avoidance: General Anti-Abuse Rule, retrieved from <https://www.gov.uk/topic/dealing-with-hmrc/tax-avoidance> (accessed on 7 July 2016)

<sup>23</sup> HMRC, Tax avoidance: General Anti-Abuse Rule, retrieved from <https://www.gov.uk/topic/dealing-with-hmrc/tax-avoidance> (accessed on 7 July 2016)

<sup>24</sup> McMahan Jr., 16 August 2010, Living with the Codified Economic Substance Doctrine, *Tax Notes*, Vol. 128, pp. 731-754

<sup>25</sup> Robert McMechan, 2013, *Economic Substance and Tax Avoidance: An International Perspective*, Carswell, pp. 218.



22. A number of civil law countries, like Spain and Brazil, have similarly applied doctrines developed by their judiciaries to counter tax avoidance. These doctrines are: “simulation”, “abuse of form”, “abuse of law” and “*fraus legis*” (Alvarrenga, 2013)<sup>26</sup>. Relying on such doctrines require the court to adopt a more purposive interpretation of the tax statute, and to investigate into the economic reality behind the legal form adopted by the taxpayer.
23. On a more practical level, a doctrine or principle of “substance over form” can only operate on an abstract conceptual level. Without more, such a doctrine would fail to provide sufficient clarity as to the correct outcome in particular cases. In many anti-avoidance regimes, for example Australia’s Part IVA and the equivalent provision in Hong Kong, the operation of the anti-avoidance rule requires the comparison of the actual legal arrangement entered into by the taxpayer with a hypothetical alternative arrangement that would achieve the same economic or commercial outcome for the taxpayer. Any comparative tax advantage that is obtained through the taxpayer’s legal arrangement (as opposed to the hypothetical alternative arrangement) is then reversed.
24. In Singapore, we have our general anti-avoidance rule legislated under section 33 of the Singapore Income Tax Act (Chapter 134) (“ITA”)<sup>27</sup>. In the case *Comptroller of Income Tax v AQQ and another appeal* [2014] SGCA 15<sup>28</sup>, the Court of Appeal held that for the Singapore GAAR to apply to an arrangement, the court will first determine whether the arrangement results in tax advantage of the type as specified under section 33(1) of the ITA (e.g. an alteration of incidence of tax or a reduction in tax liability). If it does, then the court will examine if the exception under section 33(3)(b) for arrangements with bona fide commercial reasons applies. In addition, the court will consider whether the use of specific provisions in the ITA to achieve the relevant tax advantage is within the intent and purpose of the Parliament in legislating those provisions. Objectively, the first step of this three-step step is easily met since it depends only on the

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<sup>26</sup> Simulation is essentially equivalent to the common law concept of “sham”, and occurs when the intention of the parties is different from the arrangement that the parties purport to make. Abuse of form involves the use of an atypical, abnormal or unnecessary legal form by the taxpayer to perform a juridical act, which, if carried out through a “normal” form, would have a more burdensome tax treatment. Abuse of law is the improper exercise of a right. *Fraus legis* corresponds to an indirect violation of the law, in which the taxpayer observes the literal content of the law, but to achieve a result contrary to its spirit.

<sup>27</sup> Section 33 of the Income Tax Act:

(1) Where the Comptroller is satisfied that the purpose or effect of any arrangement is directly or indirectly — (a) to alter the incidence of any tax which is payable by or which would otherwise have been payable by any person; (b) to relieve any person from any liability to pay tax or to make a return under this Act; or (c) to reduce or avoid any liability imposed or which would otherwise have been imposed on any person by this Act, the Comptroller may, without prejudice to such validity as it may have in any other respect or for any other purpose, disregard or vary the arrangement and make such adjustments as he considers appropriate, including the computation or recomputation of gains or profits, or the imposition of liability to tax, so as to counteract any tax advantage obtained or obtainable by that person from or under that arrangement...

...

(3) This section shall not apply to — (a) any arrangement made or entered into before 29th January 1988; or (b) any arrangement carried out for bona fide commercial reasons and had not as one of its main purposes the avoidance or reduction of tax.

<sup>28</sup> The case concerns the restructuring of a group of companies through the incorporation of a new entity, AQQ, and transferring the shares of a number of subsidiary companies to AQQ. The intention of the restructuring is to utilise the imputation credits that the group companies have accumulated under the then-existing imputation system for corporate tax purposes. To finance the restructuring, a fixed rate notes was obtained from a bank. Through a circuitous series of payment arrangements, the principal amount of the notes was repaid to the bank within the same day, and interest payments were generated. AQQ claimed a deduction for such interest expenses against the dividends paid by the subsidiary companies, and in the process, obtained a substantial amount of tax refund. In the absence of any cogent explanation for the complex arrangement (with round tripping of the purchase price of subsidiaries and artificial interposition of external entities when the group has sufficient resources to finance the restructuring), the Court of Appeal ruled that the Comptroller of Income Tax was entitled to invoke section 33 to disregard the whole arrangement.

existence of a tax advantage. The notion of “substance” enters the analysis through the second step in the consideration of the commercial reasons of the taxpayer.

25. In summary, in the context of tax avoidance, the determination of substance involves an analysis of the economic realities, the commercial considerations and justifications pertaining to an arrangement. This analysis also has to take into account general tax principles and an appreciation of policy objectives and Parliament’s intent behind the legislation of the tax provisions.

(D) Concept of substance in tax treaties

26. In the area of tax treaties, the concept of substance can be manifested in the beneficial ownership requirement to some extent. As already explained, the concept is also implicit in the tax residence requirements under domestic law – however, for many countries with worldwide taxation, this is largely secondary since the key question is whether the country of residence asserts a right to tax the income of the taxpayer, and not whether the taxpayer has business activities in that country.
27. Beneficial ownership is to be contrasted with legal ownership. The concept of “beneficial ownership” is based on a broad economic, rather than a strict legal interpretation of the term “ownership”<sup>29</sup>. It is based on the principle of “substance over form”: though the legal title to a property rests with the legal owner, the beneficial owner is the one who is entitled to receive the income from the property. In this way, the concept corresponds to the notion of substance, as it evaluates the economic realities of the underlying transactions.
28. The beneficial ownership requirement can be found in Articles 10, 11 and 12 of the OECD Model Tax Convention, concerning the treatment of interest, dividend and royalty. It aims to minimise treaty abuses and seeks to accord treaty benefits only to recipients who are the true owners of the income. In this respect, in order to be eligible for treaty benefits, the recipient of an income must not be a conduit merely acting on behalf of another person<sup>30</sup>. To be regarded as the “beneficial owner” of an income, the recipient of the income should have the right to use and enjoy the income, free from any obligations to pass on the same to another person<sup>31</sup>. Implicit in this concept is an assumption of the beneficial owner of the income as a “free” economic actor with financial and commercial independence from other parties in relation to the income.
29. The judge in the Canadian case of *Prevost Car Inc v Her Majesty the Queen* [2008] TCC 231 shared OECD’s view on beneficial ownership: “the ‘beneficial owner’ of dividends is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received. The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership”. In the case of *Velcro Canada Inc. v Her Majesty the Queen* [2012] TCC 57, the Canadian courts further put forth the following four factors to determine the existence beneficial ownership:
- a) **Possession** – “having or holding property in one’s power” or “the exercise of dominion over property”.
  - b) **Use** – “a long continued possession or employment of a thing for which it is adapted”.

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<sup>29</sup> Axel Smits and Isabel Verlinden, 2012, *Substance 2.0 - Aligning international tax planning with today’s business realities*, PricewaterhouseCoopers

<sup>30</sup> OECD, 2014, 2014 Update to the OECD Model Tax Convention, retrieved from <http://www.oecd.org/tax/treaties/2014-update-model-tax-convention.pdf> (accessed on 7 July 2016)

<sup>31</sup> OECD, 2014, 2014 Update to the OECD Model Tax Convention, retrieved from <http://www.oecd.org/tax/treaties/2014-update-model-tax-convention.pdf> (accessed on 7 July 2016)

- c) **Risk** – “the chance of injury, damage or loss”, or “liability for injury, damage or loss that occurs
  - d) **Control** – “to exercise power or influence over”.
30. Some countries apply the requirement for beneficial ownership in a broader manner akin to an anti-avoidance device. For example, in China’s State Administration of Taxation (“SAT”) Notice 601 issued on 27 Oct 2009, a “beneficial owner” is stated to generally engage in substantive operational activities and excludes “agents” and “conduit companies”. A “conduit company” is defined as a company established for minimising taxes, or transferring profits, established only for tax avoidance reasons. Manufacturing, distribution or management are given as examples of substantive operational activities.<sup>32</sup>
31. The SAT Notice 601 also pointed out some factors that would be considered as contrary to claim of beneficial ownership. These include an obligation to distribute or assign all or majority of the receipt within a specified time limit to a person who is resident in another country, an absence of operational activities other than holding the property or rights based on which the income is derived, and the existence of few assets or headcount that appears disproportionate to the amount of income.<sup>33</sup>

(E) Concept of substance in transfer pricing

32. The concept of economic substance features prominently in the application of the arm’s length method in transfer pricing. According to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 (“OECD TP Guidelines 2010”)<sup>34</sup>, the arm’s length basis requires a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. In order for such comparisons to be useful, the “economically relevant characteristics of the situations being compare must be sufficiently comparable”. This requires a functional analysis which seeks to identify and compare the “economically significant activities and responsibilities undertaken, assets used and risks assumed” by the parties to the transactions.
33. However, one of the criticisms for the OECD TP Guidelines 2010 is that its analysis focuses on the contractual allocation of functions, assets and risks, which could be easily manipulated. The application of the arm’s length principle in such a situation may not lead to a tax outcome that is aligned with the conduct of substantive economic activities or the creation of value<sup>35</sup>.
34. BEPS Actions 8, 9 and 10 thus aimed to strengthen and enhance the guidance in this area, and to ensure that the application of arm’s length principle will result in an outcome that aligns the allocation of profits to the underlying economic activities. In the Aligning Transfer Pricing

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<sup>32</sup> Crowe Horwath Tax Services (HK) Limited, 28 May 2010, China issued a tax notice on the interpretation and recognition of “Beneficial Owner” of tax treaties, *Tax Alert*, Issue 2, retrieved from <https://www.crowehorwath.net/uploadedfiles/hk/services/tax/taxalert2.pdf> (accessed on 7 July 2016)

<sup>33</sup> Crowe Horwath Tax Services (HK) Limited, 28 May 2010, China issued a tax notice on the interpretation and recognition of “Beneficial Owner” of tax treaties, *Tax Alert*, Issue 2, retrieved from <https://www.crowehorwath.net/uploadedfiles/hk/services/tax/taxalert2.pdf> (accessed on 7 July 2016)

<sup>34</sup> Retrieved from <http://www.oecd.org/publications/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm> (accessed on 7 July 2016)

<sup>35</sup> OECD, 2015, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, retrieved from [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports\\_9789264241244-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en#page1) (accessed on 7 July 2016)

Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports<sup>36</sup>, OECD proposed that the actual contractual relations between related parties should be examined together with the conduct of the parties. In this regard, the parties' conduct is generally regarded as the best evidence concerning the true allocation of risk and the functions assumed by the parties. The actual consequence of the supposed risk allocation is another factor to be considered in examining the economic substance of the allocation. In order to arrive at the appropriate tax outcome, where the contractual terms of an arrangement and the conduct of the related parties differ significantly or the contractual terms are not supported by actual conduct, it is possible to disregard the contract terms and apply the transfer pricing rules based on the actual conduct of the parties.<sup>37</sup>

35. Accordingly, in the context of transfer pricing, the concept of substance is to be found in the conduct of the parties and the economic consequences of the relevant transaction. The actual conduct of the parties and the substance of the transaction involved are the key tests in allocating profits arising from the transaction to the respective parties<sup>38</sup>.
36. The Australia Tax Office, in its Tax Ruling 2014/6<sup>39</sup>, provided the following views, which aptly described how "substance" is being evaluated in the context of transfer pricing:

*"[Transfer pricing] is concerned with the conditions and profits resulting from the commercial or financial relations between associated enterprises, not merely with the particular labels assigned to those relations. The form chosen to document a transaction or arrangement does not necessarily dictate its substance, or whether it is commercially rational, or inform as to whether it has been undertaken at arm's length. In applying the arm's length principle, it is important to consider the economic reality and effect of a transaction or arrangement (that is, its substance), rather than proceeding only on the basis of how it has been characterised or structured... Consequently, a key consideration is whether the transaction or arrangement conveys economic value from one enterprise to another – whether that benefit derives from tangible property, intangibles, services or other items or activities. An arm's length party will be willing to pay for an activity only to the extent that the activity confers on it a benefit of economic or commercial value... The 'substance' of the commercial or financial relations describes the economic reality or essence of those dealings and is determined by examining all of the relevant facts and circumstances, such as the economic and commercial context of the commercial or financial relations, the object and economic and financial effects of those relations from a practical and business point of view on each of the entities and the conduct of the parties, including the functions performed, assets used and risks assumed by them."*

(F) Concept of substance as applied in the context of incentive administration

37. Tax policy has been an important tool to achieve economic growth and development for Singapore. Being a small city state with limited natural resources, Singapore needs to have a tax system that supports its economic and social development, and provides sustainable revenue

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<sup>36</sup> OECD, 2015, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, retrieved from [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports\\_9789264241244-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en#page1) (accessed on 7 July 2016)

<sup>37</sup> OECD, 2015, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, retrieved from [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports\\_9789264241244-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports_9789264241244-en#page1) (accessed on 7 July 2016)

<sup>38</sup> Axel Smits and Isabel Verlinden, 2012, *Substance 2.0 - Aligning international tax planning with today's business realities*, PricewaterhouseCoopers

<sup>39</sup> Retrieved from <https://www.ato.gov.au/law/view/document?DocID=TXR/TR20146/NAT/ATO/00001> (accessed on 8 July 2016)

for the country. Besides keeping its tax rates competitive, Singapore uses tax incentives to promote investments in specific industries or activities, with the objective of generating economic spinoffs and delivering long term economic outcomes.

38. Singapore's use of tax incentives is in principle aligned with the concept that profits should be taxed where substantive economic activities generating the profits are performed and where value is created<sup>40</sup>. Tax incentives are awarded to a small group of companies for a defined time period. To be eligible for tax incentive, a company must commit to conducting substantive economic activities in Singapore and add significant value to the economy. Such commitments could be in the form of creating sizeable number of professional or skilled jobs for Singaporeans, incurring considerable business spending, including infrastructure spending, in Singapore, and also bringing in new capabilities into Singapore<sup>41</sup>. Companies being awarded with incentives are subject to regular checks of their contributions and are expected to be compliant with the Singapore tax rules.
39. For instance, criteria relating to the headquarters incentives could include the following:
- a) The applicant should be, or belong to a group that is, well established in its respective business sector or industry and has attained a critical size in terms of equity, assets, employees and business share.
  - b) The applicant should be the nerve centre in terms of organisation reporting structure at senior management levels for its principal activities with clear-cut management and control for the activities.
  - c) The applicant should have a substantial level of headquarters activities in Singapore that may include, amongst other things, strategic business planning and development, general management and administration, marketing control and brand management, intellectual property management and research and development activities.
  - d) The personnel employed by the applicant for its headquarters operations should be based in Singapore, and would include management, professionals, technical personnel and other supporting staff.

Some additional factors that may be considered include the amount of paid-up capital the company has, the percentage of skilled staff, and the quantum of business spending.

40. In this way, "substance" is to be assessed in the scope and extent of activities the company carried out or has brought into Singapore, and the level of economic contributions the company made to Singapore.

(G) Concept of substance in accounting and economics

41. Let us now examine how the notion of substance is applied in areas beyond tax. Similar to tax principles, accounting concepts are human constructs. They are formulated to meet the information needs of the owners of corporate entities. Accounting principles, and the general accepted accounting standards, govern the way financial information should be measured and represented so as to present a true and fair view of the financial situation of a company.

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<sup>40</sup> Media release by Ministry of Finance Singapore "Singapore joins inclusive framework for implementing measures against Base Erosion and Profit Shifting (BEPS)" on 16 Jun 2016, retrieved from <http://www.mof.gov.sg/news-reader/articleid/1659/parentId/59/year/2016> (accessed on 30 Jun 2016)

<sup>41</sup> EDB website, retrieved from <https://www.edb.gov.sg/content/edb/en/why-singapore/ready-to-invest/incentives-for-businesses.html> (accessed on 30 Jun 2016)

42. Accounting profit is generally defined as the difference between total monetary revenue and total monetary costs<sup>42</sup>. Monetary revenue refers to the revenue the company receives from the provision of its goods or services. Monetary costs are explicit costs the company has to incur in running the business operations. Examples of such costs are purchase of stocks, employee salaries, and utilities.
43. However, to economists, “profit” should include not only monetary revenue and costs, but also implicit gains and implicit costs<sup>43</sup>. In economics terms, implicit costs refer to opportunity costs, that is, what the company has forgone in order to use its resources in a particular manner. For example, the implicit cost from using an asset is the potential price the company could obtain from selling it. Economic profit is generally considered as a better indication of whether a company should enter or exit a market as it takes into account all the costs involved in a business operation<sup>44</sup>. Hence, it is arguably a better representation of “substance” of the business.
44. Another area where we could see the concept of substance being applied is in the area of “control”. Traditionally, for financial statement consolidation purposes, “control” is presumed to exist where there is a shareholding of 50% or more. As such, where an investor company holds 50% or more of the shares in another entity (the investee), it is required to prepare consolidated financial statements.
45. However, as commerce and economy develops, and corporate structures getting increasingly complex, a simplistic definition based on the percentage of ownership is no longer sufficient. Financial Reporting Standard 110 on Consolidated Financial Statements (effective for annual periods beginning on or after 1 January 2014)<sup>45</sup> pronounced that the existence of control is to be evaluated based on the following factors:
- a) whether the investor has power over the investee;
  - b) whether the investor is exposed to or has rights to variable returns from its investment; and
  - c) whether the investor has an ability to use its power over the investee to affect the amount of the investor’s returns.
46. Where all of the three factors are present, an investor is regarded to have control over the investee and is required to present consolidated financial statement with the investee. For the purpose of determining whether the investor has power over the investee, one has to examine whether the investor has any rights that give it the ability to direct the activities of the investee. Such rights exist not only in the form of voting rights, but may also arise from contractual relationships. In this way, accounting standard is increasingly looking into the substance of the relationship between the two entities. Instead of relying on a bright line test, for accounting purposes, one is now required to examine the facts, circumstances and the conduct of the parties in the arrangement.

(H) Concept of substance in the context of anti-money laundering and counter-terrorist financing

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<sup>42</sup> Boundless Economics, 21 July 2015, “Difference Between Economic and Accounting Profit”, retrieved from <https://www.boundless.com/economics/textbooks/boundless-economics-textbook/production-9/economic-profit-65/difference-between-economic-and-accounting-profit-245-12343/> (accessed on 10 February 2016)

<sup>43</sup> Boundless Economics, 21 July 2015, “Difference Between Economic and Accounting Profit”, retrieved from <https://www.boundless.com/economics/textbooks/boundless-economics-textbook/production-9/economic-profit-65/difference-between-economic-and-accounting-profit-245-12343/> (accessed on 10 February 2016)

<sup>44</sup> Boundless Economics, 21 July 2015, “Difference Between Economic and Accounting Profit”, retrieved from <https://www.boundless.com/economics/textbooks/boundless-economics-textbook/production-9/economic-profit-65/difference-between-economic-and-accounting-profit-245-12343/> (accessed on 10 February 2016)

<sup>45</sup> Retrieved from <http://www.asc.gov.sg/2016Volume> (assessed on 8 July 2016)

47. Corporate vehicles may be used by criminals to conceal or disguise the proceeds from crime. In the area of anti-money laundering and counter-terrorist financing, to deter and detect the misuse of corporate vehicles, it is important to have access to information relating to the persons who can exercise ultimate effective control over the corporate vehicles<sup>46</sup>. The concepts applied here is the concept of beneficial ownership and the concept of control. Beneficial owner refers to the natural person who ultimately owns the corporate vehicle or the natural person on whose behalf a transaction is being conducted<sup>47</sup>. For this purpose, it looks beyond the legal ownership and takes into account how control is actually being exercised and the identity of the person who benefits from the transaction in effect. In this manner, similar to the discussion above on tax treaties and the accounting concept of control, substance is to be found not in the legal form but the economic realities of an arrangement.

### **The significance of substance**

48. From the above survey, it may be surmised that the notion of “substance” is used in three different ways:
- a) Substance as a threshold – the notion of substance is embedded in some threshold test producing a binary outcome, for example, a taxpayer is either resident or not, a hybrid instrument is either analysed based on its legal form or not, a tax arrangement is either based on commercial motives or not, a taxpayer is either the beneficial owner of income or not;
  - b) Substance as a measure – the notion of substance is reflected in a requirement for proportionality, which is most commonly found in transfer pricing principles and is also reflected in calibrated levels of different tax incentives; and
  - c) Substance as a guide – the notion of substance is left nebulous as a guiding principle intended to be used in a broad range of situations but with no prescriptive consequence, for example the use of the concept of substance in the accounting and economic sense.
49. We consider the utility of each of these in the Singapore context and whether any useful overarching principle may be drawn therefrom to form the basis of a general rule.
- (A) Substance as a threshold
50. This usage is the most common in tax rules since the object is to produce a practical outcome. However, the binary nature of the possible outcome presents three related conceptual difficulties. Firstly, this results in the effective setting of an all-or-nothing threshold and it may be difficult for the analysis to properly give weight to different factors in a factual matrix. If the rule is used sparingly (e.g. the anti-avoidance rule), this problem is ameliorated insofar as a more considered judgment is applied, but where the rule is often used (e.g. the residence test, the beneficial ownership test), the practical consequence may be that the threshold would be set at a low level to avoid disputes. Secondly, the level of threshold needs to be set and it may be difficult to do so across the entire spectrum of business taxpayers – what is meaningful substance for one taxpayer may well be an insignificant trifle for another. Thirdly, there may be a lack of proportionality of outcomes as the taxpayer either satisfies the rule or not – there is

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<sup>46</sup> FATF, October 2014, Transparency and Beneficial Ownership (October 2014), retrieved from <http://www.fatf-gafi.org/publications/fatfrecommendations/documents/transparency-and-beneficial-ownership.html> (accessed on 8 July 2016)

<sup>47</sup> FATF, October 2014, Transparency and Beneficial Ownership (October 2014), retrieved from <http://www.fatf-gafi.org/publications/fatfrecommendations/documents/transparency-and-beneficial-ownership.html> (accessed on 8 July 2016)

no allowance for how slightly the taxpayer may have failed to meet the rule. Again, in a commonly applied rule, there would be practical pressure to set a low threshold to avoid inequitable outcomes resulting from such a cliffhanging effect. In some rules however, there is scope for a two stage analysis – a first stage to reflect a threshold test, i.e. whether a tax arrangement is tax avoidance or not, followed by a second stage to reflect a proportionate outcome, i.e. the adjustment made to a tax avoidance arrangement would be proportionate to the tax advantage obtained.

51. Notwithstanding these limitations, the setting of a threshold is practical for both compliance by taxpayers and administration by the tax authority. The mix of relevant factors that is considered in such a threshold test is of course peculiar to the object of the test. That said, the factors are invariably concerned with facts that are indicators of commercial or economic realities and that are objectively ascertainable or verifiable.

(B) Substance as a measure

52. As a general rule, for a business to be deemed to exist, we would expect there to be a proper set-up established to conduct regular and organised activities to derive a profit. Substance, in this context, is generally demonstrated in the size of the operation. A business is regarded as substantial if it employs a sizeable amount of resources and generates significant economic benefits (in terms of revenue or contributions). Factors that could be relevant in this analysis include:

- a) The duration of the operation/ the degree of permanence of the set-up;
- b) The nature of the activities conducted and the control the entity has over the conduct of these activities;
- c) The nature and quantum of assets and capital employed in the operation, having regard to the type of activities carried out by business;
- d) The degree of influence the entity has in the market or the economy, for example, its market share or its ability to tap into the capital market;
- e) Its economic contributions in terms of business spending, use of banking facilities and the creation of jobs; and
- f) Its contribution to the value chain, taking into account its relationship with the other entities that may be providing support to the operation, for example, its distributing agents or marketing agents.

53. In tax matters that require alignment of outcomes to commercial realities in a more calibrated manner, for example transfer pricing and tax incentives, the notion of substance can be shorthand for the measure against which the tax outcome is to be determined. While such a rule theoretically provides an outcome that is more consistent with commercial realities, it too suffers significant limitations. Firstly, given the myriad factors that may be relevant in different businesses or commercial transactions, the analysis is not linear but multifactorial. This means that there will be multiple dimensions of subjectivity involved in the articulation and application of the tax rule. Secondly, in transfer pricing situations, the substance of business operations only provides one aspect of the transfer pricing analysis and not the whole tax outcome – it would still be necessary to attribute the correct value to such substance. In other words, the existence of substance by no means eliminates the subjectivity and contention involved in transfer pricing analyses.

(C) Substance as a guide



54. The use of the notion of substance in this sense is not to produce administrative rules but to articulate a guiding principle. For the purposes of tax rules and tax administration, we think that this would be of limited usefulness. Such a guiding principle would not be definite enough to provide predictability of tax outcomes or to guide the resolution of tax disputes.

### **Conclusion**

55. As can be seen from above discussion, the recent development in international tax rules could be regarded as a search for “substance” and the alignment of tax outcome with substance. In this context, it is no longer sufficient to have “substance” as a vague guiding principle or a simple threshold test. The concept of substance as used in the above sense requires a measure of economic realities in order to resolve international tax issues by some norm justified by some concept of proportionality. Such an analysis would necessarily be a multi-faceted and subjective one. In this sense, it is doubtful whether there will ever be a consensus internationally on what constitutes substance or an acceptable level of substance, and the implementation of this principle would not be void of conflicts.