ECONOMIC SUBSTANCE: VIEWS FROM THE U.S., EUROPE, AND THE B.V.I., CAYMAN, AND NEVIS

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Like concepts of beauty, the presence or absence of economic substance in the tax context often is in the eye of the beholder. As importantly, economic substance means different things to tax authorities in different jurisdictions. This article looks at the concept of economic substance in three separate localities – the U.S., the E.U., and certain Caribbean jurisdictions.

THE VIEW FROM THE U.S.

Background

U.S. tax law has a doctrine known as the economic substance doctrine. The main purpose is to prevent taxpayers from entering into artificial transactions for the principal reason of reducing tax exposure. Under the doctrine, a transaction that is purely or substantially tax motivated is disregarded.

The doctrine has been recognized in the caselaw for over 90 years. In 2020, it was codified in order to have the same standard applied in U.S. courts no matter where located. In comparison to rules in the E.U. and several Caribbean jurisdictions, it applies to transactions rather than the entities conducting transactions.

Along with the economic substance doctrine, caselaw has created other doctrines meant to achieve broadly the same effect. The various doctrines include the following:

- Economic substance doctrine
- Business purpose doctrine
- Sham transaction doctrine
- Substance over form doctrine
- Step transaction doctrine

However, the lines between these doctrines are not always clear. The result is that while these doctrines serve an important role in denying improperly earned tax benefits, it adds more uncertainty for taxpayers who may be caught by such doctrines. For example, the economic substance doctrine states that tax benefits can be denied if the transaction that gives rise to those benefits lacks economic substance independent of U.S. Federal income tax considerations, even if all facts occurred. Similarly, the business purpose doctrine states that tax benefits can be denied if the transaction was not intended to serve some useful non-tax purpose. Where both a useful non-tax purpose exists alongside overriding tax purposes, some courts have bifurcated the transaction in order to disallow the tax benefits of the overall transaction. Caselaw has not always helped in drawing clearer lines.

Transactions Lacking Economic Substance

Commr. v. Court Holding Co.[1]

In this case, a corporation agreed to sell an apartment building with the intent of winding up once the transaction was completed. This would have resulted in two levels of tax: first, corporate income to the corporation effecting the sale, and second, income tax for shareholders as the sale proceeds were distributed. After agreement on price was reached, but before a written agreement was executed, the corporation visited a tax advisor who pointed out that a better tax result could be achieved if the apartment building were distributed to the shareholders as part of a liquidation of the corporation after which the building could be sold by the shareholders. Under the law in effect at the time, the corporation did not recognize gain when assets were distributed to shareholders as part of a liquidation. One level of tax could be eliminated. The form of the transaction was renegotiated. Following the advice of the tax advisor, the corporation approved a plan of liquidation and distributed the building to its shareholders. The shareholders effected the sale. The Supreme Court, reversing the Fifth Circuit, held that the corporation was still the true seller.

> The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. [Citations omitted.]

Corliss v. Bowers[2]

The taxpayer transferred a portfolio of investments to a trust formed for the benefit of his wife and children. However, the taxpayer retained significant control over the trust, including powers to modify or revoke, in whole or in part, the trust deed. The taxpayer argued that he was not liable for tax on the trust income because he never received that income. The Supreme Court disagreed and pointed out that while the assets and money were sitting in a trust, the taxpayer had actual command over the property. By analogy, the court reasoned that a taxpayer would not escape tax liability merely because it was sitting in his bank account.

> [T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid. If a man directed his bank to pay over income as received to a servant or friend, until further orders, no one would doubt that he could be taxed upon the amounts so paid. It is answered that in that case he would have a title, whereas here he did not. But from the point of view of taxation there would be no difference. * * * The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

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1 324 U.S. 331 (1945).

2 281 U.S. 376 (1930).

Commr. v. P.G. Lake, Inc.[3]

P.G. Lake was a company in the business of producing oil and gas. It owed a debt to its president. In consideration of the cancellation of its debt, Lake assigned him an oil payment right that consisted of a fixed amount and 3% of the unpaid balance that was payable out of 25% of the oil attributable to Lake's working interest. The president reported the oil payment right as long-term capital gain, taxed at favorable rates. The Supreme Court recognized that an oil payment typically produces long-term capital gain, the payment before the Court was an income payment, not a capital payment.

> The purpose of [long-term capital gains tax rates] was "to relieve the taxpayer from * * * excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. * * * We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. The pay-out of these particular assigned oil payment rights could be ascertained with considerable accuracy. * * * These arrangements seem to us transparent devices. Their forms do not control. Their essence is determined not by subtleties of draftsmanship but by their total effect. [Citations omitted.]

Minnesota Tea Co. v. Helvering[4]

Minnesota Tea Co. was indebted to creditors at the time of its liquidation. As part of the liquidation, the company sold its assets at a gain. Under the law at the time, proceeds used by the corporation to pay off its debt would be taxed but not proceeds distributed to shareholders. In a strategy somewhat similar to the one used in *Court Holding Co.,* Minnesota Tea distributed all of the proceeds to its shareholders. The shareholders subsequently used one-quarter or so of the proceeds to pay off Minnesota Tea's debts. The Supreme Court recharacterized that portion as money used by the company itself to pay off debts

> Payment of indebtedness, and not distribution of dividends, was, from the beginning, the aim of the understanding with the stockholders and was the end accomplished by carrying that understanding into effect. A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit. * * *

Rice's Toyota World v. Commr.[5]

Rice was an automobile dealership that bought a used computer for $1.5 million from a promoter as part of a sale-and-leaseback transaction. Rice paid through a

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[3] 356 U.S. 260 (1958).

[4] 302 U.S. 609 (1938).

[5] 752 F.2d 89 (4th Cir. 1985).

recourse note in the amount of $250,000 payable over three years and two non-recourse notes payable over eight years. Rice leased the computer back to the promoter under an eight-year nonrecourse lease which allowed Rice to earn annual cash-on-cash income of $10,000. The Fourth Circuit found the transaction to be a sham under a two-prong test. First, under the subjective tax, Rice's only motive was obtaining tax benefits. Second, under the objective test, there was no reasonable possibility of generating a profit.

> The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction. The record in this case contains ample evidence to support the tax court's finding that Rice's sole motivation for purchasing and leasing back the computer under the financing arrangement used was to achieve the large tax deductions that the transaction provided in the early years of the lease.
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> * * * [T]he record supports the court's subsidiary finding that Rice did not seriously evaluate whether the computer would have sufficient residual value at the end of the eight year lease to Finalco to enable Rice to earn a profit on its purchase and seller-financed leaseback. Under the purchase and lease agreements with Finalco, Rice was obligated to pay (and did pay) $280,000 to Finalco in the form of principal and interest on the recourse note. Finalco's rental payments provided Rice with a return on the investment of $10,000 annually after payment of Rice's principal and interest obligations under the nonrecourse notes. At the time of the lease, Rice could therefore be certain of receiving a $50,000 return since Finalco had subleased the computer for five years, but Rice could recover the additional $230,000 of its investment only if it could re-lease the computer after five years or realize a substantial amount by its sale. * * *
>
> Residual value of the computer (either in selling or re-leasing) should therefore have been the crucial point of inquiry for a person with a business purpose of making a profit on this transaction. However, Rice's principal officer knew virtually nothing about computers, and relied almost exclusively on the representations of a Finalco salesperson regarding expected residual value. * * *
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> The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits. * * * The record contains estimates of residual value made by several experts that range from a low of $18,000 to a high of $375,000. Although Rice's experts presented a range of predicted residual values with a high end sufficient to earn Rice a profit, the tax court found the Commissioner's experts to be more credible and to have used more reliable forecasting techniques.

The Merrill Lynch Transactions

Merrill Lynch developed a financial product to create capital losses that U.S. corporations could use to offset capital gains from other transactions. Under the financial product, the U.S. corporation would form a partnership with a foreign partner not subject to U.S. tax. The two partners would capitalize the partnership with cash contributions, primarily from the foreign partner, who would consequently become the majority partner. The partnership would purchase high-grade, floating-rate private placement notes ("P.P.N.'s") that included put options enabling the partnership to sell the P.P.N.'s back to the issuer at par.

In exchange for selling the P.P.N.'s, the partnership would receive consideration consisting of 80% cash and 20% indexed installment notes. The gain from the sales would be reported using the installment method under Code §453. Additionally, since the floating-rate notes were categorized as contingent consideration because the total amount to be received could not be determined at the time of sale, gain recognition would be accelerated but offset by deferred loss. This is because in installment sales with contingent consideration, basis is allocated equally to all years in which payment can be received.[6] A taxpayer recognizes gain if a payment in a particular year exceeds the allocated basis for the year. A payment that is less than the basis for that year is a recovery of basis. Losses are only allowed in the final year of payment.

"Since the foreign partner held the majority interest, it would be allocated the bulk of the gain in the first year."

In a simplified example from one court case involving these transactions,[7] a seller sells a property with basis and current value of $1 million in exchange for $500,000 cash and an indefinite five-year instrument. Because there are five years in which payment could be received, the $1 million in basis is allocated $200,000 to each year. In the first year, the seller receives $500,000 in cash, of which $200,000 is recovery of basis and $300,000 is gain. This leaves $800,000 in basis to be recovered. In the second year, the notes are sold for $500,000, producing a loss of $300,000 due to the remaining $800,000 of basis.

Since the foreign partner held the majority interest, it would be allocated the bulk of the gain in the first year. That gain would not be categorized as effectively connected income in the hands of the foreign partner. Consequently, no U.S. tax was imposed. The loss from the second-year sale of notes would be allocated to the U.S. partner, and was used to offset capital gains from an unrelated transaction.

In a series of lawsuits, courts struck down the transactions as a sham. There was no reason for the companies to get involved other than to produce a tax loss. Courts disregarded the existence of either the partnership[8] or the transaction.[9]

Andantech L.L.C. et al. v. Commr.

Like the Merrill Lynch transactions, this case[10] involved a manipulation of timing. Comdisco was a lessor, dealer, and remarketer of IBM computer equipment. It engaged in a sale-leaseback transaction with a partnership formed by two non-U.S. individuals. Comdisco then subleased the equipment to end users of the equipment. The partnership sold the right to receive rental payments, causing an acceleration of the rental income. Since the partners were both non-U.S. individuals, the income went untaxed. At that point, when the revenue stream was already disposed of, a

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6 Temp. Treas. Reg. §15A.453-1(c)(3)(i).

7 *ASA Investerings Partnership v. Commr.*, 201 F.3d 505.

8 *Saba Partnership v. Commr.,* T.C. Memo. 2003-31; Boca Investerings Partnership v. U.S., 314 F.3d 625.

9 *ACM Partnership v. Commr.*, 157 F.3d 231.

10 331 F.3d 972 (D.C. Cir. 2003).

U.S. corporation became a 98% partner and received its proportionate share of the depreciation deductions. There was no rental income to offset these deductions because the gain from the rental income had already been recognized.

The D.C. Circuit Court applied the sham-transaction doctrine and disregarded the partnership. The foreign partners' participation was disregarded under the step-transaction doctrine because they always intended to withdraw from the partnership. The sale-leaseback transactions were held to lack economic substance and a non-tax business purpose.

> [T]he intent of the [foreign partners] was not to run the business as a partnership or otherwise, but to assist with a transaction for which they * * * would be well compensated. Their contribution of cash was comparatively minimal and borrowed, and they withdrew almost all of it from the company after only three months, exactly as outlined in the June proposal. [The foreign partners] had only been made aware of the deal and offered their participation after an earlier pair of potential European partners backed out, and had a maximum of two weeks to consider the deal before the formation of the partnership. This, too, illustrates the lack of intent to actually enter into the partnership for a purpose other than to facilitate the proposed tax-beneficial transaction. The terms of the deal offered further evidence of the intent of the participants. For example, Andantech hired a Dutch business manager to run Andantech, but with a contract of only two and a half months, coinciding precisely with the timeline described in the proposal memo for the income-stripping transaction, and the time period in which the transaction, in fact, occurred.

Transactions Where the Taxpayer Prevailed

Frank Lyon Co. v. U.S.[11]

A state bank wanted to build a new headquarters building, but banking regulations prevented financing the new building with a conventional mortgage. Consequently, the bank entered into a sale-leaseback transaction. The bank sold the building to Frank Lyon, which financed its purchase with a mortgage and then leased the building back to the bank.

The I.R.S. argued that the sale-leaseback should be disregarded. In its view, the bank remained the true owner, and Frank Lyon should not have been allowed any depreciation deductions.

> * * * Although the rent agreed to be paid by the bank equaled the amounts due from the petitioner to its mortgagee, the sale-and-leaseback transaction is not a simple sham by which petitioner was but a conduit used to forward the mortgage payments made under the guise of rent paid by the bank to petitioner, on to the mortgagee, but the construction loan and mortgage note obligations on which petitioner paid interest are its obligations alone, and, accordingly, it is entitled to claim deductions therefor under §163(a) of the Internal Revenue Code of 1954. * * *

[11] 435 U.S. 561 (1978).

> While it is clear that none of the parties to the sale-and-leaseback agreements is the owner of the building in any simple sense, it is equally clear that petitioner is the one whose capital was invested in the building and is therefore the party entitled to claim depreciation for the consumption of that capital under §167 of the Code. * * *
>
> Where, as here, there is a genuine multiple-party transaction with economic substance that is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features to which meaningless labels are attached, the Government should honor the allocations of rights and duties effectuated by the parties; so long as the lessee retains significant and genuine attributes of the traditional lesser status, the form of the transaction adopted by the parties governs for tax purposes. [Citations omitted.]

__Twenty-First Securities Transactions__

Two U.S. corporations were approached by Twenty-First Securities Corporation, a promoter, for a series of transactions. The promoter identified American Depositary Receipts ("A.D.R.'s") of public European companies that had announced dividend distributions. The promoter arranged for an intermediary to borrow A.D.R.'s owned by tax-exempt entities that were not able to claim a foreign tax credit on the 15% dividend withholding tax. The intermediary sold the A.D.R.'s short to the corporation-taxpayer for fair market value plus 85% of the expected dividends. The stock lender received cash equal to 102% of the fair market value.

This purchase carried a settlement date before the record date for the dividends, meaning the corporation received the dividends. The A.D.R.'s would then be sold immediately with a settlement date after the dividend-record date. The second sale price was lower because it did not include the dividends, creating a loss for the corporation. And unlike the stock lender, the corporation could claim a foreign tax credit for the dividend withholding tax.

The I.R.S. lost their attempts to recharacterize the transactions.[12] In *Compaq Computer Corp. v. Commr.*,[13] the Fifth Circuit held that the transaction was a genuine multi-party transaction, made at arm's length, that had business and regulatory motives behind it, rather than only tax avoidance.

The mere fact that a tax benefit existed did not make the transaction a sham. The transaction had a reasonable possibility or profit along with a real risk of loss. Notably, Compaq made profits on a pre-tax basis, as the gross dividend income before the foreign withholding taxes exceeded the capital loss. The I.R.S. argued that the economic benefit should have been measured on a cash basis, excluding foreign tax credits. The court rejected this argument. It was inconsistent with the I.R.S.'s acceptance that the issuing corporation's withholding and satisfaction of Compaq's foreign tax liability created additional income for Compaq. The argument was also internally inconsistent because the I.R.S. wanted to treat the withholding tax as a cost but not the foreign tax credit as a benefit.

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12 *IES Industries Inc. v. U.S.,* 253 F.3d 350 (8th Cir. 2001).

13 277 F.3d 778 (5th Cir. 2001).

The benefit stemming from the foreign tax credit in this transaction is no longer possible due to Code §901(k)(1)(A)(i), which disallows the foreign tax credit for withholding on dividends if the recipient of the dividend holds the stock for fewer than 16 days in the 31-day period beginning 15 days before the ex-dividend date.

Palmer v. Commr.

A chiropractic school found its ability to obtain grants limited because of its status as a profit-making corporation.[14] The school consequently decided to become a not-for-profit entity. To effect this conversion while maximizing the tax benefit, the corporation's shareholders formed a charitable foundation and contributed their shares to the foundation. This resulted in a deduction for charitable contributions. The foundation then caused the dissolution of the corporation. This allowed the school assets to be distributed in a liquidation distribution that was tax-free at the level of the corporation under the law at the time and not taxed at the level of the not for profit foundation. The I.R.S. unsuccessfully argued that the steps should be collapsed because the taxpayer in the lawsuit controlled the foundation and knew that the corporation was to be liquidated after its contribution to the foundation.

The case raised the question of whether a taxpayer must choose the form of transaction that yielded the highest tax liability. Problematically for the I.R.S., the vote in favor of the liquidation had not yet taken place. There was no requirement that the foundation go through with the plan.

The Tax Court ruled that an expectation of an event is not enough to rearrange the order of steps chosen by the taxpayer. The I.R.S. would eventually acquiesce in Revenue Ruling 78-197.

Code: §7701(o)

Reasons for the Enactment of §7701(o)

The report from the Joint Committee on Taxation reveals the reasons behind the creation of Code §7701(o).[15] The case law, as illustrated by the cases described above and others, indicated a lack of consistency in the approach to the economic substance doctrine. No uniformity existed regarding the type of non-tax economic benefit a taxpayer must establish in order to demonstrate that a transaction has economic substance. Some courts denied tax benefits on the grounds that a stated business benefit of a particular structure was not, in fact, obtained by that structure. Other courts denied tax benefits on the grounds that the subject transactions lacked profit potential. Still others applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but these factors were insignificant when compared to the tax benefits. Also, courts differed on whether financial accounting benefits arising from tax savings qualified as a non-tax business purpose.

Several cases involved transactions structured to allocate income for Federal tax purposes to a tax-indifferent party, with a corresponding deduction, or favorable basis result, to a taxable person. The income allocated to the tax-indifferent party for tax purposes was structured to exceed any actual economic income to be received by the tax-indifferent party to the transaction.

[14] 62 T.C. 284 (1974).

[15] JCX-18-10.

Codification of the Economic Substance Doctrine

To help create a more unified doctrine, Congress enacted a statutory version of the economic substance doctrine. The codified rule provides that a two-prong test must be met in order for a transaction to have economic substance. The provision provides that, in the case of any transaction to which the economic substance doctrine is relevant, a transaction is treated as having economic substance only if

- the transaction changes in a meaningful way the taxpayer's economic position, apart from Federal income tax effects; and
- the taxpayer has a substantial purpose for entering into such a transaction apart from Federal income tax effects.

Under the second prong of the test, a taxpayer's non-Federal-income-tax purpose for entering into a transaction must be substantial. The provision does not mandate a minimum return. Rather, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

State or local income tax effect which is related to a Federal income tax effect will be treated in the same manner as a Federal income tax effect. Achieving a financial accounting benefit will not be treated as a purpose for entering into a transaction if the origin of the financial accounting benefit is a reduction of Federal income tax. Fees and other transactions are taken into account as expenses in determining pre-tax profit, and foreign taxes are to be treated as expenses per the Regulations.

"Under the second prong of the test, a taxpayer's non-Federal-income-tax purpose for entering into a transaction must be substantial."

The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if Code §7701(o) was not enacted.

Basic Business Transactions

The J.C.T. report states that the provision is not intended to alter the tax treatment of certain basic business transactions that are respected under longstanding judicial and administrative practice merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Illustrative examples of such transactions given by the J.C.T. report include the following:

- The choice between capitalizing a business enterprise with debt or equity.
- A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment.
- The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under Subchapter C of the Code.
- The choice to utilize a related-party entity in a transaction, provided that the arm's-length standard of §482 and other applicable concepts are satisfied.

As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Additionally, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.

Code §6662 Penalty

A 40% penalty applies under Code §6662(b)(6) where any portion of an underpayment is attributable to one or more undisclosed, non-economic substance transactions. The penalty calls for strict liability, and reasonable-cause arguments are not relevant. Reliance on the opinion of counsel is irrelevant, also. If the non-economic substance transaction is disclosed, the penalty is reduced to 20%. The disclosure is generally made on Form 8275 (Disclosure Statement). However, if a taxpayer takes a position that a Regulation itself is invalid, the appropriate form is Form 8275-R *(Regulation Disclosure Statement)*.

Notice 2010-62

The I.R.S. has issued Notice 2010-62, which advises taxpayers of the following:

- The law will be applied literally.
- Once it is determined that economic substance is relevant, both prongs of the legislative economic substance test must be met.
- Application of existing caselaw that applies only one leg of the two-pronged test will be challenged.
- The I.R.S. will not issue a Private Letter Ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of §7701(o).
- The I.R.S. will continue to analyze when the economic substance doctrine will apply in the same fashion as under prior law.
- If authorities under prior law concluded that the economic substance doctrine was not relevant in determining whether certain tax benefits are allowable, the I.R.S. will continue to take that position.
- The I.R.S. anticipates that caselaw will continue to develop. This may be a euphemism that existing caselaw will be challenged.
- The I.R.S. does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.

Recent L.B.&I. Guidance

Previously, approval by the Director of Field Operations was required before the codified economic substance doctrine could be formally asserted. This reflected congressional concerns about overzealous I.R.S. examiners. But in 2022, the L.B.&I. (Large Business & International) Division issued a memorandum that removes the requirement to obtain executive approval before asserting the codified economic substance doctrine. Taxpayers are at greater risk of running afoul of the economic substance doctrine.

THE VIEW FROM THE EUROPEAN UNION

Background

Over the last decade, the international tax framework for holding companies operating in the European Union (the "E.U.") has grown increasingly complex. This complexity arises, *inter alia*, from the proliferation of anti-abuse rules designed to curb aggressive tax planning and ensure fair taxation. As a result, non-E.U. investors face a genuine challenge in navigating the fine line between legitimate tax planning, which may or may not be earmarked as aggressive, and abusive tax avoidance.

This section of the article aims to serve as a practical guideline to prevent E.U. holding structures from being classified as abusive leading to the potential denial of tax benefits.

We will first explore the advantages and restrictions associated with E.U. holding structures. Subsequently, we will delve into the primary abuse of rights within the E.U., drawing lessons from the so-called "Danish Cases" of the Court of Justice of the European Union (the "C.J.E.U."). Then, we will discuss the forthcoming substance requirements within the E.U. under the proposed Unshell Directive, also known as the third Anti-Tax Avoidance Directive ("A.T.A.D. 3"). Finally, we will review the similarities and differences between the Organization for Economic Co-operation and Development's ("O.E.C.D.") approach, specifically under the Principal Purpose Test (the "P.P.T."), and the E.U.'s approach under the general anti-abuse rules ("G.A.A.R.") found in the Parent-Subsidiary Directive (the "P.S.D.") and the A.T.A.D, as well as the general abuse principle recognized in the C.J.E.U.'s Danish Cases.

Tax Advantages and Restrictions for Holding Structures in the E.U.

Holding structures established or operating within the E.U. benefit from tax advantages under the applicable Double Tax Treaties ("D.T.T.") and national laws of E.U. Member States. In addition, they benefit from the following:

- Protection under E.U. primary law, namely the fundamental freedoms guaranteed by the Treaty on the Functioning of the European Union (the "T.F.E.U."), *i.e.*, the free movement of goods, services, persons, and capital.

- Potential advantages under E.U. secondary law, mainly the P.S.D. and the Interest and Royalties Directive (the "I.R.D."), which provide, *inter alia*, for no withholding tax ("W.H.T.") on dividend or interest payments made within the E.U. under specific circumstances.

Note, however, that the E.U. restricts or denies tax benefits for holding structures deemed abusive under the following:

- The general anti-abuse principle contained in E.U. primary law, as recognized in the C.J.E.U.'s "Danish Cases" that we will analyze below.

- Several anti-abuse provisions found in E.U. secondary law, including the following:

    - The Merger Directive (2009/133/CE) includes a Specific-Anti-Abuse Rule ("S.A.A.R.") under Article 15.

    - The P.S.D. (2011/96/E.U.) includes a S.A.A.R. under Article 1, §§ 2-4.

- The I.R.D. (2003/49/E.C.) includes a S.A.A.R. under Article 5.
- The A.T.A.D. (2016/1164/E.U.) includes a G.A.A.R. under Article 6.

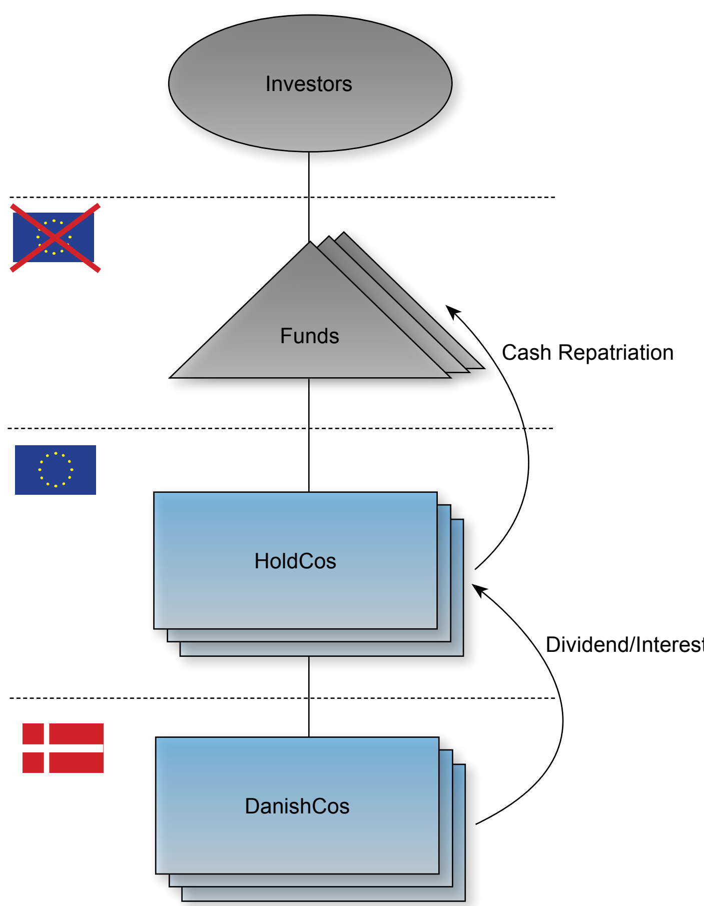
- Other relevant initiatives, such as the following:
  - The Directive on Administrative Cooperation ("D.A.C.") (2011/16/E.U.), which promotes cooperation among E.U. tax authorities to combat tax evasion and avoidance.
  - The E.U. Council's List of Noncooperative Tax Jurisdictions, which identifies jurisdictions that do not meet E.U. standards of tax transparency and cooperation.

Abuse of Rights in the E.U.: Lessons From the "Danish Cases"

In February 2019, the Grand Chamber of the C.J.E.U. delivered two landmark judgments, known as the "Danish Cases," addressing the issue of directive shopping under the P.S.D. and the I.R.D.

Since then, tax authorities in several Member States – including Belgium, France, Italy, the Netherlands, Spain, and Denmark – have relied on the Danish Cases to tackle cases of alleged directive shopping.

Background



The main question in the Danish Cases was whether dividend and interest payments made by Danish operating companies to parent companies in other E.U. Member States such as Luxembourg, Cyprus, and Sweden were eligible for the W.H.T. exemption in Denmark when the income was fully or partially passed to non-E.U. ultimate parent companies and private equity funds located outside the E.U. in places such as Bermuda and the United States

The taxpayers applied the Danish W.H.T. exemption based on the P.S.D. and the I.R.D. However, the Danish tax authorities denied the W.H.T. exemption claiming that the E.U. parent companies were not the beneficial owners ("B.O.'s") of the payments but mere conduit companies. The case eventually ended up before the Danish High Court, which sought an answer from the C.J.E.U. regarding a preliminary question

General Anti-Abuse Principle

The Danish Cases raised the issue of how the prohibition of abuse of rights should be interpreted and applied under E.U. law. Specifically, the Danish courts asked the C.J.E.U. whether a Member State needed to implement a domestic anti-abuse provision to address abusive practices related to the P.S.D. and I.R.D.

This question was particularly relevant at the time because Denmark had not yet incorporated the P.S.D.'s anti-abuse provision into its national law. Therefore, the critical question was whether Denmark could deny tax benefits to a taxpayer under an anti-abuse provision that had not yet been implemented into national law.

Under the caselaw applicable at the time, a Member State could not apply a specific rule found in a directive if that Member State did not implement the directive into its national law. For example, in the *Kofoed* case (C-321/05), the C.J.E.U. considered that the anti-avoidance provision of the Merger Directive (20019/133/EC) reflected the general Community law principle that abuse of rights are prohibited, but required, that the transposition of an anti-avoidance rule be derived from the domestic general legal context to be in line with the principle of legal certainty. Therefore, and as expected, Advocate General Kokott followed the same conclusion in her opinion on the Danish Cases.

However, the C.J.E.U. disregarded the Advocate General's position and ruled that the E.U. principle regarding abuse of rights applies to prevent fraud or abuse even if domestic legislation has not been enacted. In other words, the C.J.E.U. ruled that Denmark had an obligation to counter abusive practices, even in the absence of a domestic G.A.A.R. in its national law or tax treaties. By doing so, the C.J.E.U. elevated the prohibition of abuse of rights to the rank of a general principle of E.U. primary law.

Note, however, that this principle applies only to rights derived from E.U. primary or secondary legislation, but not to rights based solely on domestic law or tax treaty laws of Member States.

Criteria to Assess Abuse

To determine the existence of an abuse, the C.J.E.U. reiterated the two-pronged tests provided in the *Emsland Stärke* Case (C-110/99), where it held the following:

> [A] finding of an abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the [E.U.] rules, the purpose of those rules has not been achieved [and, second] a subjective element consisting in the intention to obtain an advantage from the [E.U.] rules by creating artificially the conditions laid down for obtaining it.

In other words, the E.U. G.A.A.R. incorporates an objective component (*i.e.*, causing the purpose of the applicable rule to be defeated) and a subjective one (*i.e.*, the intention to artificially obtain an advantage).

Even if the subjective and objective elements of the abuse concept can sometimes be difficult to distinguish in cases such as *Cadbury Schweppes* (C-196/04), which involved a wholly artificial arrangement, it is important to note that these two components remain separate.

In the Danish Cases, the Court held that the following elements are suggestive of abuse, even if they must be considered jointly with all of the other facts and circumstances:

- Dividends are passed on to companies that would not have benefited from the advantages granted by the P.S.D. or the I.R.D. without the interposition of the intermediary holding company.
- The intermediary holding company makes little or insignificant taxable profit in the Member State where it is established, as payments that are received are primarily forwarded to a non-E.U. companies.
- The sole activity of the intermediate holding company is to receive dividends and pay them to the B.O. or another entity. This activity, however, must be assessed based on all the relevant facts regarding management, financial statements, costs incurred, staff, premises, and equipment.

Beneficial Ownership

Since the I.R.D. limits the eligibility for the interest W.H.T. exemption to the B.O. of the income, the Danish court requested the C.J.E.U. to provide guidance on the meaning of the term "B.O." and on the relevance of the O.E.C.D.'s Model Tax Convention ("Model Treaty") and its commentaries for its interpretation.

The situation was different for the benefits granted under the P.S.D., as this directive does not include a B.O. test. Consequently, the issues surrounding the P.S.D. cases focused on the interpretation of the term "B.O." within the D.T.T.'s between Denmark and the jurisdictions of the E.U.-parent companies.

In both instances, the C.J.E.U. ruled that the concept of B.O. should focus on the actual recipient of the income, regardless of the person formally identified as such.

Practically speaking, a recipient will be deemed to be the B.O. where it receives the income for its own benefit. In contrast, a person is not a B.O. where it acts as an intermediary, such as an agent, trustee, or authorized signatory for someone else. In this respect, it is crucial for the recipient to be able to determine the use of the income freely.

Advocate General Kokott proposed interpreting the B.O. concept autonomously under E.U. law, without regard to the commentaries on the O.E.C.D.'s Model Treaty She suggested that non-E.U. countries would otherwise have a say in the interpretation of the I.R.D. Nevertheless, the C.J.E.U. decided to adopt a more dynamic approach and stuck with the O.E.C.D.'s Model Treaty and its commentaries for interpreting the B.O. concept.

In a nutshell, the C.J.E.U. indicated that, in accordance with the O.E.C.D. commentaries on B.O., the fact that there is a legal or contractual obligation to pass on the dividend or, in fact, that dividends are passed on, should serve as an indication of abuse. Interestingly, the C.J.E.U. reproduced the O.E.C.D. commentary language, linking B.O. to a person that has the ability to use and enjoy those dividends.

Requirement of a Tax Advantage

The C.J.E.U. also reiterated the idea that a tax advantage is a *sine qua non* condition for abuse under E.U. law. In other words, there is no abuse if, in lieu of paying dividends directly to the B.O., a company decides to interpose an intermediate company without, however, benefiting from any tax advantage.

Burden of Proof

The C.J.E.U. diverged from Advocate General Kokott's opinion regarding the burden of proof in cases involving the B.O. receiving dividends and the denial of benefits under E.U. secondary law.

For the Court, national tax authorities are not required to automatically identify the B.O. but can request information from taxpayers to assess whether an abuse exists. If a taxpayer refuses to provide the requested information, benefits may be denied.

This does not mean, however, that there is a shift in the burden of proof from national tax authorities to taxpayers. The authorities still bear the responsibility of investigating potential abuse and must provide reasoning for the denial of benefits. However, this investigation can occur in certain cases, typically within the context of a tax audit, for which taxpayers are required to furnish the requested information.

Upcoming Substance Requirements – A.T.A.D. 3/Unshell Directive

On the legislative front, one of the tax developments in the E.U. is the Proposal for a Council Directive laying down rules to prevent misuse of shell entities for tax purposes. Introduced by the European Commission in December 2021, the Directive is commonly referred to as A.T.A.D. 3 or the Unshell Directive.

In the Explanatory Memorandum of the draft Proposal, the Commission explains the purpose of the directive:

> While important progress has been made in [the area of ensuring fair and effective taxation] in the last years, especially with the adoption of the Anti-Tax Avoidance Directive (A.T.A.D.) and the expansion of scope of the Directive on Administrative Cooperation (D.A.C.), legal entities with no minimal substance and economic activity continue to pose a risk of being used for improper tax purposes, such as tax evasion and avoidance, as confirmed by recent massive media revelations.

In fact, within the E.U., legal personality is granted by Member States based on purely formal requirements such as minimum capital or minimum number of shareholders and without any review or checks of the economic activity of the entity. Therefore, it is relatively easy for non-E.U. investors to interpose an E.U. entity to enjoy advantageous tax treatment under D.T.T.'s, E.U. primary law such as the fundamental freedoms or secondary law such as the P.S.D. and the I.R.D., and national laws of Member States.

To combat inappropriate use of shell companies, the draft Proposal proposes rules to identify shell entities in the E.U., allow for the exchange information among Member States about identified shell entities, and deny E.U. tax benefits to identified shell entities. Purportedly, the goal is not to make shell entities disappear, but to avoid their abusive use for tax purposes.

If adopted and implemented, undertakings deemed as lacking minimal substance would be denied treaty benefits and benefits under E.U. primary and secondary law, particularly under the P.S.D. and I.R.D.

First Step: Is the Entity in Scope?

All E.U. entities are in scope, except entities with listed securities such as publicly traded stocks or bonds and regulated entities. In the initial proposal by the Commission, entities with at least five full times employees are also out of scope. However, this exclusion was removed by the European Parliament.

Note that, in contrast with the O.E.C.D.'s Pillar 1 and 2 initiatives, the A.T.A.D. 3/Unshell Directive is not limited to large M.N.E.'s.

Second Step: Is the Entity at Risk?

The proposed Directive sets elements to identify undertakings that are at risk for lack of substance and potential misuse for tax purposes. It initially specifies the criteria that should lead to the obligation for taxpayers to report their substance on their tax returns. To be "at risk," an entity must meet three criteria:

- More than 65% of its income or assets are categorized as passive
- More than 55% of its activities or assets relate to cross-border transactions
- Administration and management are outsourced to a third-party

If an entity is at risk, it must report in its annual tax return whether

- premises are available for its exclusive use (shared use by entities of the same group also counts),
- at least one E.U. bank account is active, and
- at least one qualified director or the majority of the full-time employees live close to the undertaking and are involved in the decision-making process.

The current Proposal suggests that Member States impose a penalty of at least 2% of the entity's turnover for incorrect reporting or failing to report. In the event of a false declaration, an additional penalty of at least 4% of the entity's revenue would be imposed.

National tax authorities must assess each year whether an entity or undertaking is a shell based on the information furnished by the company. A presumed shell entity can present proof to show it has genuine economic activity and sufficient nexus with the Member State of which it claims to be a tax resident. Even if an entity is not a shell under the A.T.A.D. 3/Unshell Directive, it may still be still be considered a shell under national law.

Third Step: What if the Entity is a Shell?

Shell entities are not eligible for tax benefits under the network of D.T.T.'s in force and effect of the Member State in which tax residence is claimed. Also, it is not considered to be resident of that State for purposes of claiming benefits of certain European Directives, such as the P.S.D. and the I.R.D.

Similarities in the O.E.C.D. and E.U. Approaches to Abusive Tax Structures

Comparing the indicia used by the O.E.C.D. and the E.U. to determine the existence of abuse, certain factors are similar under both sets of rules.

Legal (Non-Tax) Reasons and Political Advantages

In the *Centros* Case (C-212/97), the C.J.E.U. acknowledged that the choice of an individual to incorporate a company in a Member State cannot be the sole reason for a corporate structure to be deemed abusive so that tax benefits are denied under E.U. law. The court stated:

> Choosing to incorporate in a Member State] whose rules of company law seem to him the least restrictive * * * cannot, in itself, constitute an abuse of the right of establishment.

Along the same line, the O.E.C.D. Model Treaty commentary on Article 29(9)(Example F) identifies factors that are considered legitimate for establishing a company in a specific jurisdiction. Included are the following:

- Skilled labor force
- Reliable legal system
- Business-friendly environment
- Political stability
- Membership of regional grouping
- Sophisticated banking industry.

Mere Presence of an Intermediate Holding is Not Decisive

In the *Eqiom* Case (C-6/16), the *Deister Juhler* Case(C-504/16), and the Danish Cases (C-116/16), the C.J.E.U. acknowledged that the mere interposition of a holding company cannot be the sole determining factor for identifying an abusive situation. Likewise, having a single owner or ultimate owner in the holding structure is not automatically an indication of abuse. The O.E.C.D. Model Treaty commentary on Article 29(9) is in line with this approach.

Multiple Investments

The fact that a holding company has multiple investments is an indication of non-abuse. This appears to be relevant for both the O.E.C.D. and the C.J.E.U. as implied in the *Deister Juhler* Case (C-504/16) and in the Danish Cases (C-116/16).

Beneficial Ownership

This concept is relevant for both the O.E.C.D. Model Treaty and the C.J.E.U. even though the outcome might be different.

Nationality or Residency of Ultimate Owner

Even though the C.J.E.U. appeared not to find the nationality/residence of a taxpayer relevant in the *Eqiom* Case (C-6/16) and the *Deister Juhler* Case (C-504/16), the opposite approach was taken in the Danish Cases (C-116/16). In the Danish Cases, the fact that the ultimate beneficial owner was based in a third country and would not benefit from the same favorable tax treatment had it received the income directly was indicative of abuse. By doing so, the C.J.E.U. aligned itself with the O.E.C.D. criteria.

Limited Economic Activity

The C.J.E.U. indicated multiple times that limited economic activity can be analyzed with other facts and circumstances as an indication of abuse. Companies that merely receive and pass on dividends are targeted by this approach. This is also the O.E.C.D.'s approach.

It should also be noted that, even though not yet formally adopted and subject to modifications, the A.T.A.D. 3/Unshell Directive brings additional substance elements to the analysis that imply abuse.

Differences in the O.E.C.D. and E.U. Approaches for Assessing Abusive Tax Structures

Despite their similarities, the O.E.C.D. approach with the P.P.T. and the E.U. approach with G.A.A.R. contain three main differences. As a result, the same set of facts and circumstances may be deemed abusive under one test, but not on the other.

Scope of Application

While the P.P.T. applies only in situations involving benefits derived from a D.T.T., the E.U. G.A.A.R. has a more comprehensive reach. The A.T.A.D., for example, applies to all taxpayers subject to corporate tax in one or more E.U. Member States, including entities with permanent establishments ("P.E'.s") in E.U. territories. In both instances, the P.P.T. and the G.A.A.R. have a subsidiary character, meaning that they apply even when a S.A.A.R. is applicable.

Abuse Threshold

On the one hand, the E.U. G.A.A.R., influenced by caselaw from the C.J.E.U., focuses on artificiality in arrangements, categorizing them as non-genuine and lacking valid commercial reasons reflecting economic reality. On the other hand, the O.E.C.D.'s P.P.T. employs a reasonableness test, evaluating the primary purpose of a transaction or structure and its relationship to core commercial activities.

Burden of Proof

In the E.U., the responsibility of demonstrating abuse lies primarily with tax authorities, who must collect and present evidence to support their claims. In contrast, under the O.E.C.D.'s P.P.T., tax authorities bear the burden of proof regarding the element of intent while the taxpayer bears the burden of proof that the transaction is within the object and purpose of the particular benefit that is claimed under the applicable D.T.T.

"The legislation adopted by the B.V.I. and Cayman are similar in nature and require that an entity which carries on a relevant activity as defined below is required to satisfy the appropriate economic substance test in relation to the activity."

VIEW FROM THE B.V.I., CAYMAN, AND NEVIS

Background

This portion of the article focuses on economic substance legislation in the British Virgin Islands, the Cayman Islands, and Nevis.

The British Virgin Islands ("B.V.I."), Cayman Islands ("Cayman"), along with fellow U.K. Crown Dependencies and Overseas Territories, introduced Economic Substance Legislation in response to concerns of the E.U.'s Code of Conduct regarding favorable tax regimes. The targets of the Code of Conduct are those jurisdictions and tax regimes in non-E.U. Member States that generate profits without proper economic activity, resulting in potentially harmful economic consequences to Member States of the E.U. For this purpose, harmful economic consequences generally refer to lost tax revenue in the E.U. Member State with no offsetting tax imposed abroad or to hidden income of a tax resident in an E.U. Member State.

The legislation adopted by the B.V.I. and Cayman are similar in nature and require that an entity which carries on a relevant activity as defined below is required to satisfy the appropriate economic substance test ("E.S. Test") in relation to the activity.

Nevis is part of the Federation of St. Christopher ("St. Kitts") and Nevis (the "Federation"). While it is not a U.K. Crown Dependency or Overseas Territory. Nevis adopted a regulatory initiative requiring companies to file simplified tax returns with the local tax authority. The Nevis legislation draws no distinction between entities carrying relevant activities and those that do not.

Additionally, all three jurisdictions adopted legislation as part of their commitment to comply with the Base Erosion and Profit Shifting ("B.E.P.S.") initiative of the O.E.C.D., with a focus on B.E.P.S. Action 5 covering intellectual property regimes.

B.V.I. and Cayman

If a relevant entity In the B.V.I. and Cayman carries on at least one relevant activity, it must submit a return to the local authority. In the B.V.I., the local authority is the International Tax Authority and in Cayman it is the Department of International Tax Co-operation (each of which is the "T.I.A.").

Self-Certification

The return is submitted on an annual basis, providing certain prescribed information and demonstrating how the relevant entity has satisfied the E.S. Tests set out in the relevant legislation. The T.I.A. reviews the return and determines whether the relevant entity satisfies the E.S. Test.

The process of determining whether a relevant entity is in scope for economic substance purposes is one of self-certification by its directors or controlling persons. However, the local authority has made it clear that each relevant entity will need to demonstrate the process leading to the self-certification. The material will be held in the entity's permanent files and will be made available to the T.I.A. upon request. Where a relevant entity conducts more than one relevant activity, the E.S. Test must be met in respect of each relevant activity.

Relevant Entities

In general, a relevant entity includes the following:

- A company that is incorporated in the B.V.I. or Cayman and an LLC formed in Cayman.
- A limited partnership registered in the B.V.I. or Cayman. For this purpose, a limited partnership formed in the B.V.I. includes a partnership without legal personality.
- A company incorporated outside of the B.V.I. or Cayman and registered as a foreign entity under the relevant local companies act.

Relevant entities do not include the following ("Excluded Entities"):

- Investment funds. However, if the investment fund conducts one or more separate and distinct activities that fall within the definition of a relevant activity under the local regime, it will be a relevant entity as to those activities. As a result, Directors and controlling persons must be mindful of the Economic Substance Act. Prudence dictates that a determination should be undertaken each year as to the scope of activities carried on by the investment fund other than investment business.
- An entity that is tax resident outside the B.V.I. or Cayman. While these entities are Excluded Entities, a return is required demonstrating tax residence abroad.
- Ordinary domestic companies resident in Cayman
- Trusts
- Not for profit associations

Relevant Activity

All B.V.I. or Cayman entities must submit a notice to the T.I.A. confirming whether a relevant activity has been conducted during the reporting period. Relevant activities include each of the following:

- Banking business
- Distribution and service center business
- Financing and leasing business (without consideration are excluded)
- Fund management business (B.V.I. Approved Manager exemption)

- Headquarters business
- Holding company business (pure equity holding entities have reducing economic substance return requirements)
- Insurance business
- Intellectual property business
- Shipping business

Requirements of the E.S. Test

A relevant entity conducting at least one relevant activity will satisfy the E.S. Test, if the relevant entity

- conducts core income generating activities ("CIGA") from within the B.V.I. or Cayman in relation to that relevant activity,
- is directed and managed appropriately from within the B.V.I. or Cayman, and
- having regard to the level of relevant income derived from the relevant activity carried out from within the B.V.I. or Cayman
  - has an adequate amount of operating expenditure incurred in the jurisdiction,
  - has an adequate physical presence, and
  - has an adequate number of full-time employees or other personnel with appropriate qualifications in the jurisdiction.

In applying the last bullet of the E.S. Test, the term "adequate" means as much or as good as necessary for the relevant requirement or purpose. The term "appropriate" means suitable or fitting for a particular purpose, person, or occasion.

Outsourcing

In both the B.V.I. and Cayman, a relevant entity can satisfy the E.S. Test in relation to a relevant activity by outsourcing relevant CIGA to another person in the B.V.I. or Cayman. Where that path is taken, the entity must monitor and control how the CIGA is carried on by the third party in the jurisdiction. If the CIGA is monitored and controlled by someone outside B.V.I. or Cayman, the E.S. Test will not be met.

While the relevant entity in the outsourcing arrangement files the tax return and self-certifies its compliance, the T.I.A. is in contact with the service provider who may need to verify information submitted to the T.I.A. by the relevant entity.

In no event may the outsourcing be employed to circumvent the E.S. Test.

Economic Substance Classification and Filing

For both jurisdictions, the Directors and controlling persons of the relevant entity are responsible for classifying and ensuring submission of the applicable Economic Substance return with the local authority.

Penalties

Financial penalties can be imposed in the B.V.I. or Cayman for non-compliance or failing to meet the E.S. Test. Penalties are also imposed for the failure to file the Economic Substance Return and for the failure to file the return on time. If the compliance failure is criminal in nature, Cayman law calls for fines and imprisonment.

Nevis

The Federation operates a worldwide system of corporate income tax. Companies that are tax resident in the Federation are taxable on a worldwide basis. Companies that are not Federation tax residents are taxed only on income that is sourced in the Federation. This approach to tax differs significantly from the approach that adopted by the B.V.I. or Cayman.

Tax Residence

The Federation is a commonwealth jurisdiction. Federation law does not define the term "resident." Consequently, the term resident is interpreted by reference to common law.

In broad terms, a company is deemed to be tax resident in the jurisdiction where management and control occur. Tax residence in the Federation is determined by the central management and control test, as established under common law.

Central management and control is not daily operational management. Normally, central management and control is considered to be located in the jurisdiction where the board of directors convene and make management decisions on behalf of the company. This general rule is supplemented by ensuring that the board of directors is capable of making business decisions. Consequently, board members must consist of individuals suitably qualified and capable of managing the affairs of the company. Key strategic decisions of the company (especially relating to its business should be made at meetings of the board of directors. These decisions relate to capital structure, business strategy, investments, and dividend policy. All these requirements should be documented in minutes of meetings of the board of directors.

"In broad terms, a company is deemed to be tax resident in the jurisdiction where management and control occur."

If a company's management and control are located outside the Federation and no income is generated within the Federation, it will not be considered a tax resident of the Federation. Thus, it is important for the board of directors to serve a real function in the governance of a Nevis company. The delegation of corporate secretarial type functions to third parties in the Federation will not result in the company having its central management and control in the Federation.

Business Enterprise

Where a company is tax resident is determined separately from where it has its legal seat. A company's incorporation in the Federation does not mean it will be tax resident there. It is also possible for a company to be incorporated outside the Federation and a tax resident in the Federation.

Where a company is not tax resident in the Federation, it will be taxable in the Federation if activities carried on in the Federation amount to a Business Enterprise. A resident/non-resident company must take a factual approach of its business operations to assess if it meets the definition of having a Business Enterprise, and thus taxable in the Federation on its income connected with operations carried out in the Federation. This must be done on a case-by-case basis.

Where a company has a Business Enterprise in the Federation, it would be liable for tax. Alternatively, where a company is not tax resident in the Federation and does not have a Business Enterprise in the Federation, it would fall outside the scope of tax and would not be taxable in the Federation.

The establishment of a financial account in the Federation should not give rise to the nonresident having a Business Enterprise in the Federation. Similarly, the delegation of corporate secretarial, shareholder nominee services, or other administrative functions to corporate service providers in the Federation should not lead to the creation of a Business Enterprise in the Federation.

Tax Returns

Taxable entities in the Federation must file the required tax return on an annual basis. The tax return is due not later than three and one-half months after the fiscal year-end of the entity.

The official filing date depends on the delivery method. If the tax return is hand delivered, the return will be date stamped by the Inland Revenue Department (the "I.R.D.") on the day it is received by the department and that date will be considered the filing date. If the tax return is mailed or delivered by some other delivery method, the postmarked date will be considered the date of filing. In the event that a tax return is filed late, penalties and interest will be applied.

Entities classified as nonresidents will be required to file a Simplified Tax Return annually with the I.R.D. This requirement to file the Simplified Tax Return for non-resident entities applies to all entities that are registered under the Nevis Business Corporations Ordinance and the Limited Liability Companies Ordinance. Directors of Nevis corporations and managers of L.L.C.'s are required to sign a declaration and provide the I.R.D. with information about tax residence, activities, and income of entities.

The Simplified Tax Return will need to be filed by the local registered agent of the entity. However, all required information must be provided by the directors or managers of the entity.