

IOTA WORKSHOP

Indicators That May Flag a Lack of Real Economic Substance

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Conduct prevails over contract

Tax consequences should reflect the actual commercial and financial relationships between associated enterprises, not merely their contractual expression. Where allocation and conduct diverge, conduct prevails.

THE SIX QUESTIONS

- 1 **Do contractual terms reflect actual conduct?**
The contract is the starting point; conduct supplements or replaces it.
- 2 **Does the entity perform economically significant functions?**
Not administrative or ministerial acts — functions a third party would pay for.
- 3 **Are strategic decisions made by qualified personnel there?**
Competence and authority, evidenced — not merely appointment.
- 4 **Are risks genuinely controlled by the entity?**
Capability to decide, actual performance of that decision-making, and financial capacity to bear the consequence. This is the question that carries the weight.
- 5 **Are assets effectively managed rather than merely held?**
Legal title without management does not attract a return above a risk-free one.
- 6 **Do profits correspond to value creation?**
The output test, not an independent test. If the five above are answered no, this one cannot be answered yes.

LAYERS OF SUBSTANCE

- 01 **Legal substance**
Incorporation, trade licence, registered agent, filed accounts, tax residence certificate.

Every shell satisfies this. Finding it proves nothing.
- 02 **Operational substance**
Premises, payroll, resident directors, local bank account, board minutes — the visible apparatus of an enterprise.
- 03 **Decision-making substance**
Who exercises commercial authority, and who has the capability and the capital to assume and manage the risk allocated by contract?

Cannot be purchased. Where cases are won and lost.

Ten indicators — and the three tiers that decide whether an act survives

No single indicator is conclusive. The method is cumulative: one flag is a question, a pattern across families is a finding. Write up by family, not as a list of ten — a tribunal reads a pattern more readily than a list.

THE TEN, IN FIVE FAMILIES

People and decision-making

- 1 Lack of qualified employees
- 2 No real decision-making capacity

Physical and functional

- 3 Absence of physical presence
- 4 Inconsistent functional profile

Risk and capacity

- 5 Lack of risk control
- 6 Limited financial capacity

Intangibles

- 7 Passive ownership of intellectual property
- 8 DEMPE functions performed elsewhere

Transaction structure

- 9 Circular cash flows
- 10 No commercial purpose



PROBATIVE ON ITS OWN

- Bank mandate and payment authority exercised outside the jurisdiction
- An internal comparable — an independent party on the same transaction or route
- Contractual risk allocation the entity has no capital to bear
- Registry filings that contradict the transfer pricing documentation



STRONG BUT CORROBORATIVE

- No qualified personnel capable of the function claimed
- DEMPE performed wholly in another jurisdiction
- Frozen intragroup balances across consecutive years
- Contracts dated after the transactions they govern
- Return on operating expenses far outside a service-provider range



WEAK ALONE — COMMONLY MISUSED

- Low net margin on high turnover
- Small headcount, without reference to the function
- Registered address shared with other companies
- Nil property, plant and equipment for an inherently asset-light activity
- Location in a low-tax jurisdiction

Caution: it is not a checklist. Generally, substance is not a finding. It is an input to accurate delineation. It fixes the *characterisation*, which fixes the *tested party*, the *method*, and the *cost base*.

People and decision-making · physical presence and functional profile

QUALIFIED PERSONNEL AND DECISION-MAKING CAPACITY

The useful question is not how many people are employed. It is: name the individual who set this price, and produce their contract of employment.

WARNING SIGNS

- No full-time employees, or employees shared across dozens of unrelated entities
- Directors employed by a corporate service provider, holding many concurrent mandates
- Personnel without qualifications relevant to the function claimed
- Identical board minutes across numerous companies; resolutions signed without discussion
- Instructions originating exclusively from another jurisdiction

TESTS THAT DISCRIMINATE

- Seniority test: is there any person at the entity who could overrule the parent?
- Are the individuals registered locally for social insurance and work authorisation?
- Do board minutes record deliberation, or ratify decisions already executed?
- Do email headers, system logs and approval thresholds locate authority where the contract does?

*Caution: outsourced management is not by itself a finding. The question is whether **effective oversight** was retained.*

PHYSICAL PRESENCE AND FUNCTIONAL PROFILE

Physical presence is a weaker indicator than it once was. The mismatch between declared function and demonstrated capacity is far stronger.

WARNING SIGNS

- Virtual office only; registered address shared with a large number of licences
- No dedicated premises, business equipment or operational facilities
- Licence category inconsistent with the activity actually conducted
- A large share of group profit for invoicing and administration

HOW TO TEST THE MISMATCH

- Take each function asserted in the local file and match it to an identifiable cost, asset or employee
- Where a function cannot be matched to any line of the cost base, it was not performed
- Compare the operating cost structure against an independent operator performing the same function
- Check whether goods, data or personnel ever physically reach the jurisdiction

Risk and capacity · intangibles · circularity and commercial purpose

CONTROL OF RISK AND CAPACITY · 5 & 6

Contractual assumption of risk is not assumption of risk. The entity must be able to decide on the risk, actually decide on it, and survive it.

THE CONTROL TEST

- Capability to identify and assess the risk — is anyone there competent to do so?
- Authority to accept, decline or mitigate, evidenced by a decision, not a clause
- Ongoing monitoring — position reports, exposure limits, escalation records
- Where another group company performs these activities, the return follows that company

THE FINANCIAL CAPACITY TEST

- Extremely low equity against the exposures contractually assumed
- Complete dependence on intragroup funding, with no external facility of its own
- No capacity to absorb a loss of the size the risk could generate

EVIDENCE Board and committee risk papers · exposure and position reports · · guarantees given and received

PASSIVE IP OWNERSHIP AND DEMPE · 7 & 8

Legal ownership of an intangible entitles the owner to protect it. It does not, without more, entitle the owner to the return it generates.

WARNING SIGNS

- Royalty income with no research direction, development control or innovation funding
- Legal protection managed by another group entity or by counsel instructed elsewhere
- Commercialisation strategy set outside the owning entity; the owner signs only
- Intangible acquired intragroup shortly before the licensing arrangement began

THE DEMPE QUESTIONS

- Development — who directed and funded it, and where did the researchers sit?
- Enhancement — who decided on and paid for improvement?
- Maintenance — who bore the ongoing cost?
- Protection — who instructed and paid for enforcement?
- Exploitation — who negotiated and set the commercial terms?

EVIDENCE R&D contracts and cost records · inventor employment records · registration and litigation files with the instructing party · intragroup acquisition agreement

CIRCULAR FLOWS AND COMMERCIAL PURPOSE · 9 & 10

: would this structure exist in the absence of the tax benefit?

CIRCULARITY INDICATORS

- Back-to-back loans on matched terms with no margin for risk
- Financing that returns to its origin through a chain of entities
- Inflows and outflows identical in amount and near-identical in date
- Immediate onward distribution of receipts, leaving no capital in the entity
- Intermediaries that alter no term of the underlying transaction

RATIONALE — TESTED, NOT ASSERTED

- Operational efficiency — does the structure reduce a real cost?
- Market access · regulatory requirement · financing · investment protection

EVIDENCE Bank statements evidencing the full payment chain · loan agreements and schedules · board papers recording the rationale at the time

What a genuine trader does, and what distinguishes a paper intermediary

FUNCTION → DOCUMENTARY TRACE

Origination
Third-party purchase contracts, broker confirmations

Freight and logistics
Charter parties, bills of lading, demurrage claims

Blending and quality
Tankage leases, inspection certificates, blend records

Price risk management

Trade finance
Committed facilities, letters of credit, borrowing base certificates

Market intelligence
Analyst headcount, price-reporting subscriptions, research output

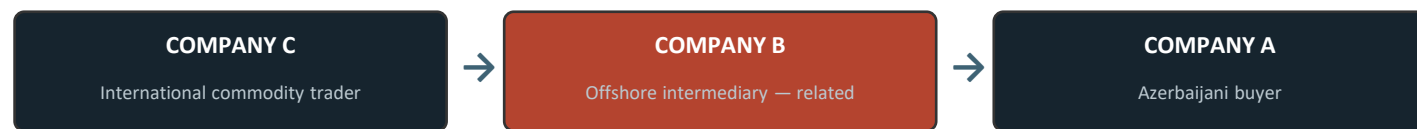
Optionality
Contract terms plus evidence that destination, timing and quotational-period options were actually exercised

Function	A genuine trader shows	A paper intermediary shows
Origination	A material share of purchases from independent suppliers	Purchases almost entirely from related parties
Freight	Charter parties in its own name; demurrage exposure	Buys and sells on the same delivery term; no charter, no freight risk
Storage and blending	Tankage contracts, inspection certificates, blend records	No storage; title transfers without the cargo stopping
Price risk	Exchange or OTC hedging, margin, mark-to-market	No hedging instruments; therefore no capacity to bear price risk
Credit risk	Own credit assessment of buyers; receivables insurance	Parent guarantees or credit-insures; no independent exposure
Financing	Committed external trade finance in its own name	Funded on current account by the parent, uncommitted
Market intelligence	Analysts, subscriptions, proprietary research	No research cost base; prices taken from the counterparty
Remuneration	Variable margin reflecting outcomes, positive and negative	Fixed spread or fixed fee — the economics of an agent
Conclusion	Entitled to share in trading profit	Entitled to a routine return on its own cost base

Be fair about the limits: an entity may perform some of these functions and not others, and the right answer is often a partial adjustment rather than a reclassification.

The transaction, and the functional analysis

An illustrative case built on a real fact pattern. The figures are those on the file; the legal characterisation is not a decided position.



COMPANY D — independent broker, involved in the underlying transaction

~5,882 t

crude palm oil

4.8%

contractual margin to B

Indonesia

origin, delivered via Black sea port

WHAT THE TRANSACTION VALUE IS MADE OF

Commodity purchase cost · transportation · insurance · handling · financing · other third-party costs

Is Company B's contractual margin consistent with the functions it performs, the assets it uses and the risks it controls?

SECTION 3 · FUNCTIONS, ASSETS, PEOPLE

Company B appears to perform

Purchase and resale · transaction coordination · limited logistics arrangements · administrative activities

Limited evidence of

Strategic commodity trading · independent procurement strategy · significant market development · substantial inventory management · significant price-risk management

THE INFORMATION REQUEST, ALMOST WORD FOR WORD

Who negotiates the commodity price? Who selects the supplier? Who decides when and how much to purchase? Who controls financing? Who manages price exposure? Who makes logistics decisions? Where are these decisions actually made?

The greater the return claimed, the greater the evidence required that the entity performs the functions behind it.

A consistent pattern across families

Family	Evidence (fact)	Assessment
People · decisions	Prices negotiated and suppliers selected by Company A’s procurement director (correspondence)	Key decisions taken outside Company B
Money flows	Company A’s CFO is sole signatory on Company B’s bank account	Payment authority outside Company B
Risk & capital	No hedging, insurance or storage; prepaid by Company A	No price, credit or financing risk borne
Presence & function	Bills of lading show goods moving directly from Company C to Company A	No logistics function performed

Assessment: Company B is a low-function intermediary performing invoicing and documentation services — not a full fledged trader.

Risk control, characterisation and the cost base

CONTRACTUAL RISK IS NOT CONTROLLED RISK

- Apply the same three-part test to each risk in turn: inventory, commodity price, logistics, credit and foreign exchange
- Risk belongs to the party with both the financial capacity and the decision-making capability to control it
- Legal title and contractual position should not, by themselves, justify a significant trading return

Company B obtains financing → interest is built into the price
→ Company A ultimately bears the cost.

Does Company B control and bear these risks — or does it pass the costs through to Company A?

FORM SAYS TRADER — THE EVIDENCE SAYS

- Limited personnel; limited operational infrastructure
- Limited asset base; no significant inventory
- No significant intangibles
- Limited strategic decision-making
- Substantial pass-through costs

THE INDEPENDENT BROKER

Company D — unrelated — brought procurement, regional market knowledge, palm oil supply, logistics and price analysis.

If an independent broker performs the key market and procurement functions, what economically significant functions remain for Company B?

The presence of an intermediary in the contractual chain does not mean it is the entity creating the trading value.

CHARACTERISATION, METHOD, COST BASE

1 Characterisation

A limited-risk trading / intermediary entity rather than a fully fledged commodity trader — which would show corresponding people, expertise, decision-making, assets, market functions, risk control and financial capacity.

2 Method

Tested party: Company B, as the less complex party.

Indicator: **gross profit ÷ operating expenses**

— return measured against the resources actually used to perform B's functions.

3 Cost base

Should Company B earn a mark-up on the entire third-party cost? Not necessarily.

A cost legally incurred by B does **not automatically mean that cost should economically earn a mark-up for B.**

Before any ratio is quoted: which costs are Company B's own, and which are pure pass-through?

Where economic substance enters Azerbaijani tax law

Four entry points, and they are genuinely different instruments. Start here: an auditor needs to know what the assessment is actually made under.

ARTICLE 14-1

Transfer pricing and the arm's-length principle

- The central provision. Tests the remuneration of a controlled transaction against what independent parties would have agreed.
- Adjusts the price or margin, re-characterization or disregard
- Scope, method hierarchy and the comparison interval sit in Art. 14-1 and in the 2017 TP Rules

ARTICLE 14-2

Controlled foreign enterprises

- Three cumulative tests:
- **control** (>50% of votes, capital or profit, with related persons, direct or indirect) ·
- **effective tax** ≤ 75% of the tax payable under our Code ·
- **listed income categories**.
- 14-2.1.3.6 — income from goods and services creating no economic value — is a substance test written into the Tax Code itself.

ARTICLES 13.2.69–13.2.71 · 23.1.6-1 · 13.2.81

The tax-avoidance scheme rule

- Where a field tax audit finds a scheme whose main purpose is a tax advantage, tax, interest, sanctions and fines are recalculated on the actual economic indicators — amount, volume, period of performance and conditions.
- Attacks the structure, not the price. 13.2.81 (goods-less transaction) is the narrower relative of the same idea.

ARTICLES 13.2.16.14-1 · 125.1.9

Withholding at source on listed jurisdictions

- Payments made directly or indirectly by residents and by PEs in Azerbaijan to persons established in a listed country, to their branches elsewhere, or to bank accounts held there, are Azerbaijani-source income — taxed at 10% at source. The list is approved annually under Art. 128.3.
- A payment for works or services also falls within 125.1.5; each 10% charge is applied separately.
- Carve-outs: debt securities, inbound investment and local deposits, wages and pensions, state duties and permits.
- Asks less about substance — it is keyed to registration, which is why it should be checked first.