EVOLUTION OF CORPORATE SUBSTANCE WITHIN THE iGAMING INDUSTRY

A long read on how technological advancements have prompted the evolution of corporate substance, disrupting regulatory frameworks in the process.

Through time, substance tests have been used to determine and allocate the location of factual management of companies, allowing countries to divide regulatory control (licensing, taxation) over those companies. However, as technology advances in a rapid pace, facilitating new ways of doing business, these tests are becoming infinitely complicated, to the point of becoming inoperable. Bas Jongmans, gaming and tax attorney and Xavier Rico, LegalTech Consultant with Gaming Legal Group, discuss how the evolution of substance is impacting iGaming companies in particular.

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Introductory

It is a fact, that automation has played a significant role in how companies do business. Regulators have not had much luck, adapting to this new reality. The problem is that, due to the rapid development of technology, the organization of virtual services, such as games of chance, is becoming too complex for current fiscal standards to cope with. A typical game of chance has many more organization 'hubs'. For example, who makes the decisions about voluntary exclusion of addicted players (self-exclusion)? At what location are matters of complaint handling executed? Where are the bank accounts with the players' deposits held? It should then have to considered how important each organization 'hub' is for the continuity of the game of chance. That is undoable.

In this article we shall discuss the evolution of substance through time. We discuss initiatives of the European Union to counter tax evasion. We will discuss how the nations of Malta, the Netherlands and Curaçao have been coping with these challenges, caused by the evolution of substance. Subsequently, we shall provide our own view on what could be solutions for the future. We shall conclude this article with some final thoughts.

Development of substance through time

For the better part of the 20th century, there was little need for the allocation of corporate substance, for tax purposes for example. No companies could exist without a physical presence, combined with on-location factual management. Such management would be highly independent, as the technology required to establish sufficient communications with remote management simply was not available.

In 'mobile' situations - maritime expeditions for example - allocation of substance would also not lead to problems, as jurisdiction would be, and still is, allocated to the flag of the respective vehicle.

At the end of the *Interbellum*, on the verge of the second world war, the first European service companies contemplated relocation of key elements of their business to 'exotic' locations, for different reasons than exploiting natural resources. At that time, expeditions were nothing new. Oil Company Shell opened its refinery in Curaçao in 1918, profiting from newly found lucrative oil resources in Venezuela, enjoying a very broad concession and subsequently leaving its lasting mark on the island of Curaçao for many decades to come.

A substantial difference with these earlier expeditions is that multinationals, such as Shell, contemplated relocation of corporate elements, not so much with the intention of exploiting natural resources on location, but rather for a very different reason, namely in order to prevent the realization of existential threats of becoming nationalized to benefit the war effort, or even being expropriated by rival foreign powers, or private parties collaborating with those rivals.

Just for the purpose of building a legal defense, management over operations on the European mainland would be transferred to distant locations, outside of Europe. It led to the birth of corporate service companies such as the Curaçao International Trust Company ("Citco").

Services would advance over time, to include relocation of management for the purpose of creating tax benefits, such as the so-called Antilles Route

("Antillenroute"), that was designed specifically to (legally) prevent taxation on dividend distributions. These services advanced into the establishment of so-called Offshore Financial Centers ("*OFC's*"). Companies located in those centers would be allowed to benefit from special tax regimes, such as the Curaçao E-zone, limiting taxation to a minimal 2% corporate income tax.

Combined with international rulings and tax treaties that were highly favorable to the offshore resident (factual) ultimate beneficial owner, it would guarantee that taxation on any level (company as well as legal individual) would be kept at a comfortable minimum. Fiscal arrangements gave a boost to the corporate services industry, sometimes beyond imagination. The Kingdom Fiscal Arrangement of the Netherlands (Belastingregeling voor het Koninkrijk or "BRK") is an example. The 1955 US tax treaty is another, exempting payments of dividend, interest and royalties from the US to the Antilles wholly or partly from the 30% US withholding tax. These reductions further boosted the establishment of offshore financial service companies in Curaçao. [1]

As the corporate services industry commercially advanced further, with the offered remote management becoming less private and, hence, more affordable, as a result, these services became increasingly more available to smaller enterprises. The reputation of the industry with the general public declined as a result. After all, it is complicated to explain, why a smaller company with a physical presence on the European mainland, a small workshop or store, should not be taxed in the nation where this physical presence exists. This would for obvious reasons not be the location where the distant management (shared with multiple other entrepreneurs) would reside.

This led to the call for substance tests, allocating taxation to so-called permanent establishments. Profits allocated to these permanent establishments would still be part of the income of the entity, generated worldwide. Based on this principle, however, de facto taxation over profits would reside with the country in which the permanent establishment is located, rather than to the country, hosting the (exotic) entity.

The Digital Revolution in the late seventies, also known as the Third Industrial Revolution, through time, proliferated the use of digital computers and digital record-keeping in private businesses. Although these were exciting times, bringing new business opportunities, it also signaled that the conventional way of allocating substance, indeed had a shelf-life and would not be able to go on forever. The shift from mechanical and analogue technology to digital electronics, gave rise to the development of new types of digital, cross-border offered remote services. This resulted in a new type of 'fluid' substance, so to speak, as a remote service would traditionally always have to include a collaboration between several points of substance.

In 1993, for example, the Governor of Curaçao established a National Ordinance, allowing the operation of so-call hazard games on the international market via service lines. [2] It gave a new boost to the corporate services industry. Approximately ten years later, not long after the millennium, the internet went mainstream. It led to a mind-blowing multiplication of business opportunities.

"This resulted in a new type of 'fluid' substance"

These opportunities, however, did introduce equally challenging regulatory problems. After all, the jurisdiction of nations used to be protected by conventional physical barriers. After all, in order to sell merchandise, one needed a physical store. With the rise of ecommerce, this natural protection of jurisdiction quickly became a thing of the past. It eroded the need for physical points-of-sale. Over time, also the need for points of production on fixed locations eroded. This would give opportunity to entrepreneurs to 'obtain' the regulatory desirable jurisdiction, managing each component of the business separately. This started to erode the opportunities for countries to levy tax corporate income taxes.

The solutions of the European Union continue to lack vision

A notable, however misguided, first attempt to intervene and limit the 'fluidity of substance' can be found in the publication of the EU Directive on Electronic Commerce on July 17th, 2000 (the "E-commerce Directive"). [3] The E-commerce Directive recognizes that certain legal obstacles *"hamper"* the *"development of information society services within the Community"*. The fifth recital of the E-commerce Directive reads:

"*The development of information society services within the Community is hampered by a number of legal obstacles to the proper functioning of the internal market which make less attractive the exercise of the freedom of establishment and the freedom to provide services; these obstacles arise from divergences in legislation and from the legal uncertainty as to which national rules apply to such services; in the absence of coordination and adjustment of legislation in the relevant areas, obstacles might be justified in the light of the case-law of the Court of Justice of the European Communities; legal uncertainty exists with regard to the extent to which Member States may control services originating from another Member State.*"

The E-commerce Directive as a proposed solution, in short, introduces storage devices as a permanent establishment for tax purposes. An approach that was doomed to fail from the start.

It should have been clear that this would invite extensive (fruitless) debates over the specific function of servers, as this storage technology continues to advance in an exponential rapid pace, causing servers to shift functions over time, multi-tasking, sometimes to perform in an auxiliary or preparatory capacity, sometimes in a primary capacity. Nowadays, the need for geographically distributed servers for data only exists because of the great need for bandwidth, speed, or for redundancy purposes. Storage of data happens anywhere and everywhere. No specific data points can be allocated to points of sale, or even physical points of production.

A fundamental course change transpired in 2013. By request of the G20 international forum for governments and central bank governors (*"G20"*), OECD produced its 15 standards (also referred to as *"Actions"*), aimed at the prevention of domestic tax base erosion and profit shifting (*"BEPS"*) .

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These Actions are aimed at enhancing an international *"level playing field"* by, for example, introducing obligations in legislation to provide for *"substance"*: to have an actual presence and/or establishment as a requirement to claim favorable tax features. Since then, its *"framework members"* have been in the process of implementing these

Actions. Such implementations are subject to *"peer review"*. [4]

In short, the EU decided to ban countries from international trade, who would continue to offer favorable tax arrangements to resident companies that would not hold sufficient substance. This approach however would also be doomed to fail, as the key problem of tax base erosion exists in the changing nature of substance itself. The said EU initiative left substance criteria unmolested. Economies shifting towards digital trade cannot escape redefining minimum substance criteria.

Malta

A clear example of this struggle may be found in the efforts of the government of Malta. This nation set out to present an ambitious National Blockchain Strategy *("NBS")*, consisting of six separate key projects, aimed at transforming the island into an economic superpower in the emerging Crypto Global Economy. Malta held its first long-anticipated Malta Blockchain Summit in 2018. [5]

Steve Tendon, a former strategic adviser (2016) for the Ministry of Economy, Investment and Small Business ("MEIB") and the first Chairman of the Blockchain Malta Association ("BMA"), notes on his website that "crypto-economy" should not be limited to cryptocurrencies alone, but to the broader new dimension of economic enterprises that can work on top of cryptographic technologies, which typically are blockchain technologies.

Such enterprises do not necessarily require a physical presence, or "classic" substance so to speak. By creating a legal environment where such enterprises can thrive, his idea would be to attract those kinds of businesses to Malta. [6]

Regulators would be able to follow the blockchain/publicly qualifying cryptocurrency and the chain of transfer. There would be no need to access paper files and records from various intermediaries. Ergo: no need for 'conventional' substance.

One could even take the position that 'conventional' substance within these high tech companies would be no substance at all. What use has a rented office building to the company? Would it be a core component, in accordance with the standards of the E-Commerce Directive?

If substance criteria would not follow technical evolution, this would stimulate the 'scam artists' of the future. Suppliers of empty office buildings, filled with a surrogate staff, all in the name of pretense.

Malta's development into the *"Blockchain Island"* seems to have gone stale. In a fascinating (and brutally honest) article on the birth of the Blockchain Island concept, Tendon claims that Malta completely *"missed the point"* on the power of cryptocurrencies. The opportunity of shifting services to the digital realm was *'lost'* by forcing companies to put down a physical presence on its shores. The nation fell into the trap of following its 'classic' existing model for success: attracting foreign investments and making companies set up a physical presence on the island. Tendon aimed to create an entirely virtual jurisdiction. This could then serve to connect cryptocurrencies and blockchain technologies to the rest of the global financial system.

Cryptocurrencies would not only offer multiple advantages when it comes to sending cross-border payments, peer-to-peer transfers or reducing fees. The possibilities, in principle, would be infinite. Ultimately, it was perceived as a too bold move, that Malta ultimately was ultimately unwilling to take". [7]

As said, in the view of Tendon, the idea of Malta becoming a dominant player in the fully virtual crypto-sphere, was lost. Its insistence on pushing the requirement for crypto-companies setting up a physical presence, is in his view entirely unsustainable.

It would be a constant drain on the island's limited resources. Based on this view, Malta could soon become even more heavily overpopulated with a searing housing crisis, an insufficient infrastructure, and a diminishing quality of life for its people.

That Malta was not prepared to follow this visionary, is a shame. It is hard to overstate the innovative potential of cryptocurrencies. From a financial perspective, cryptocurrencies offer a number of clear and unique advantages over existing technologies and currencies, including almost real-time, cross-border, peer-to-peer transfer and settlement of values at affordable fees.

The Netherlands

In the Netherlands, the courts have been divided for a long time on whether or not iGaming company *PokerStars* is located for tax purposes inside or outside of the European Union. The need for this discussion has been triggered by a ruling of the Supreme Court of the Netherlands that parts of the Netherlands' Gaming Tax Act have been declared in contravention with the European freedoms. As a result, the Netherlands is no longer allowed to levy gaming tax on winnings, made with gambling on websites ran by iGaming companies, established within the EU. [8]

The concern holds it iGaming license in Malta. Its organization, however, is located in Isle of Man. The Supreme Court of the Netherlands has ruled in the matter that it is of no importance, who the organizer of the game of chance is, as there is rarely only one single organizer. [9] This has also been the viewpoint of the Appeals Court of Arnhem-Leeuwarden in its ruling of April 25th, 2017 :

"Games of chance require game rules. When multiple organizers are involved decision-making and coordination is necessary for organizing international tournaments and cash games." [10]

In reality, this practice is even more complicated. Important policy making, but also implementation, does not necessarily take place within one's own structure. For example. A specific organization that determines the payout policy of a game of chance directs various teams of persons who determine per player whether payouts are made and if so, depending on what conditions. This service is typically referred to as *"payment processing"*. Sometimes the payment processor is part of the structure, of the gaming company, sometimes an external, unaffiliated solution has been sought for that functionality, sometimes both.

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It cannot be ruled out that those who make decisions about payouts in this regard, one of the 'key' parts of the game of chance, are not themselves part of the gaming structure itself, are not even associated with the entity, that is economically responsible for the game of chance. And this is just one of the lesser complicated examples. The introduction of the first so-called *"provably fair"* games of chance is already a fact. These are games of chance in which the entire implementation, without any human factor, takes place by means of a *"blockchain"*.

Curaçao

Curaçao, in the light of its National Risk Analysis *("NRA")* was 'invited' by the Organization for Economic Co-operation and Development *("OECD")* to make the necessary changes for the implementation of Actions. This de facto started the clock for the Government of Curaçao on a countdown from two years to a deadline of 1 July 2018. Failure to properly and timely implement these Actions would place Curaçao on a blacklist for trade with the EU. Such a dark scenario becoming reality could, overnight, make economies that are heavily based on corporate services, such as that of Curaçao, fall out of grace with well-established international clientele. On the other hand, the Government could not just abolish these regimes, but rather needed to find a way to retain a favorable business climate, hence presented with a 'pretty pickle'.

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Gaming and Tax Attorney, Bas Jongmans, AML Specialist, founded the Gaming Legal Group in 2011. He became internationally known for winning various essential procedures to the gaming industry. Bas is a regular guest on Dutch Business Radio.

It became silent for a long time. With the deadline of 1 July 2018 approaching rapidly, the government of Curaçao realized that it was compelled to act in order to avert immediate financial disaster.
On 14 June 2018, a proposal was presented to the Curaçao parliament. It was approved two weeks later, on 28 June 2018, which was one business day away from the deadline. There were no (significant) comments or changes. [11]

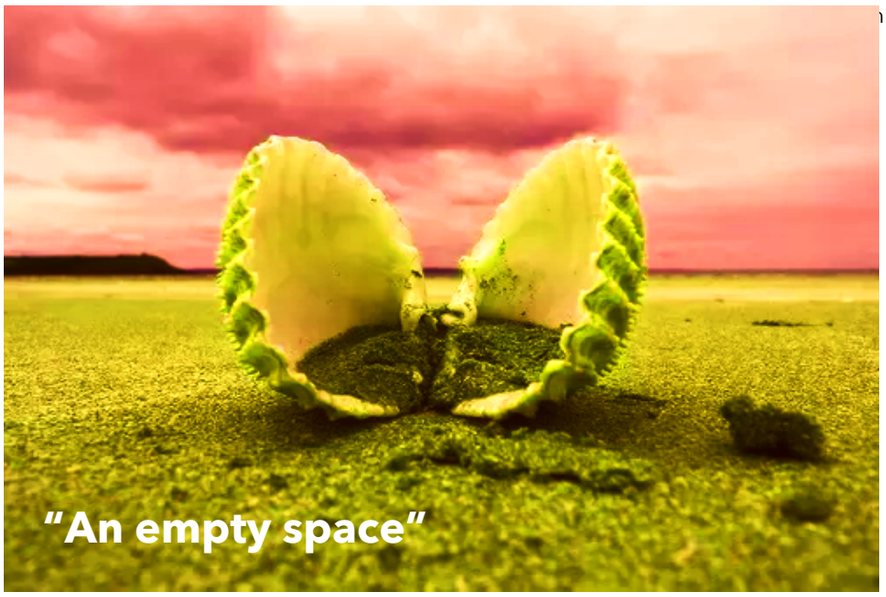
The impact of this new legislation has been significant. For instance, the definition of foreign income has, based on a principle of territoriality, been redefined to include income, connected to sales of goods and rendered services to clients abroad. Excluded from this principle, however, is income connected to services rendered in connection with legal and financial advice, insurance and shipping. Under the new legislation, companies shall only be deemed to have a 'factual presence' on the Curaçao, if sufficient local and operational costs have been allocated to the local entity. Under the new profit tax regime, the entity will be confronted with a 22% tax rate, unless it meets all new requirements. The standard profit tax exemption for income from a permanent establishment with effective management in another jurisdiction, was abolished overnight.

Under the new rules, companies are required to have a *'real'* presence. This - mainly - means that there needs to be the necessary expertise of resident (non-executive) professionals who, in their field, have the knowledge to properly arrange for all local compliance obligations (matters such as bookkeeping, taxation), supplemented with additional (Executive) expertise within concern, found abroad, related to the topic of iGaming in particular (responsible gaming, end user care, technical requirements, AML).

Imagine the impact of this overnight decision on the corporate services industry, after two years of doing nothing. It was made without any consultation with the industry. No whitepapers, no heads-up, no nothing. Unprepared and without any vision.

Opportunities

As already mentioned, both of Malta and Curaçao did not redefine their definitions of substance, which has resulted in corporate service providers doing exactly what we feared, renting out empty office buildings and setting up unused phone lines as this, for those lacking sufficient vision or knowledge, would be the definition of growing substance. It painfully shows the lack of



understanding of these peers on the advances in mainstream technology.

It is evident that certain elements of expertise (handling of end user requests, payments services) are necessary for properly operating an iGaming company would only be available in a cross-border constellation. One shall have to face reality and therefore properly identify and allocate that substance, in our view, by appointing a natural individual that is personally involved with the operation, as a supplement to the substance within the nation of the iGaming company. That person should be a member of the board of directors, with a limited mandate as an Executive Director ("Executive"). This person as a member of the board would be equally liable. This shall help to educate the Executive, taking the responsibilities of the iGaming company serious. We expect it to enhance the communication between the Executive and the resident Non-Executive, of who the latter would be responsible to fulfill all compliance obligations.

The point is: one cannot and should not pretend for the sake of creating (fake) substance that these services would be rendered onshore. This would just be pretense. It would be a so-called facing. An empty space surrounded by a meaningless brick wall.

The tracking of locations nowadays belongs to mainstream technology, such as Gmail, Dropbox, Adobe, IOS and Android. Any need for expertise abroad (for example in the event of material incidents) would lead to an extensive track record between the Non-Executive and the Executive. Also the undersigning of agreement has quickly become a thing of the past. This has been further advanced by the introduction of eIDAS (EU Regulation 910/2014), an EU regulation on electronic identification and trust

All of this makes the said practice of 'facing' fruitless and even silly. It makes individuals who shall continue on this path, potentially subject to criminal prosecution, as facing would in principle qualify as an attempt to circumvent, in an illegal way, an unfavorable tax rate.

After all, the nature of corporate services cannot be ignored. If one would pretend that all company substance would remain with the corporate service provider, to whom would that corporate service provider provide its services? Even bolder, and equally sillier, would be a company that would control, de facto run its own corporate service provider from abroad, using a local representative as its facing. In this setup, the iGaming company as well as the corporate service provider would have no substance whatsoever. The problem is even further highlighted in structures in which so-called 'white-labeling' would be involved, in which the manager of a specific website uses the technical services of a much larger, professional organizer, which functions under the license of that organizer and subsequently the profit (a *"revenue share"*) is paid.

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Next to the professionally unqualified, fortunately also visionaries exist. Revisiting Tendon, the former advisor to the Malta government, who we mentioned earlier. Tendon seems to have now found a new partner in the Republic of the Marshall Islands ("RMI"). Ironically, a nation even far smaller in (geographical) size than Malta. The capital *Majuro* is a 13 km2 strip of land surrounding a 300 km2 lagoon.

Tendon: *"RMI truly encapsulates the 'blockchain island' problem: a situation of extreme isolation and an urgent need to forge connections - connections which are not rooted in the constraints of geography, space and physical resources."*

In short: RMI did dare to redefine the meaning of substance. As a result, no need for empty office buildings, which would be key to its success, as RMI (as Malta) would not have the space anyway. RMI introduced the Marshallese sovereign ("*SOV*"). It is a unique *"crypto-fiat"* currency, in the view of Tendon aimed at creating prosperity not for just one nation but having a greater impact on the world. It is about social responsibility and even changing the very fabric of society with a deep concern about sustainability issues, social justice and distribution of wealth. [12] A great example of how a small nation with limited *'conventional'* capacity can lift itself from its bootstraps, if able and willing to let go of the past and focus on the future.

Conclusion

In this article, we have discussed the many challenges to regulators that have been presented by the evolution of substance. What should be the starting point for a viable solution for the future? The problem arises that, due to the rapid development of technology, the organization of virtual services, such as games of chance, is becoming too complex for current fiscal standards to cope with. The modern game of chance can be compared to a virtual department store, a virtual airport, where a flurry of different parties come and go, are involved, interacting in a complex process. Where the sum is more than the equal of its parts.

Only some of those parts are attributable to the *'organization of that organization'*. When they do, a tax can be imposed, such as an airport tax. A generally limited tax that is only intended to combat the costs for the joint organization only (safety, parking, landing rights). How does that work out in a virtual environment? In such a complex setting, only a single classic remedy works: *'follow the money'*. Find the intersection where all payments come together. After all, someone has to pay for all of these services, with payments coming from capital raised by players, who have lost their stake. It would be very complex to prevent

those cash flows from intersecting somewhere. It would also immediately become clear where the focus of the structure should be for AML purposes. This solution is also *'crypto-proof'* at the same time. Our advice would therefore be, especially to nations such as Malta and Curaçao, to follow in the footsteps of RMI. Only he who shall follow the rainbow, shall find the pot of gold.

Endnotes

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[2] Landsverordening van de 8ste juni 1993 houdende bepalingen betreffende het exploiteren van hazardspelen op de internationale markt middels servicelijndiensten en tot wijziging van het Wetboek van Strafrecht van de Nederlandse Antillen.
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[12] Steve Tendon, *"Will the Real Blockchain Island Please Stand Up!?",* chainstrategies.com, September 2019.