

Economic substance requirements for companies in Crown Dependencies and other jurisdictions

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BACKGROUND

New legislation has been introduced in the Crown Dependencies of Guernsey, Jersey and Isle of Man, as well as in Bahamas, Bermuda, BVI and Cayman Islands, which now ensures that certain entities based in those territories can demonstrate sufficient local economic substance. The start date varies slightly among jurisdictions, but for the Crown Dependencies the legislation is effective for accounting periods commencing on or after 1 January 2019.

The Crown Dependencies have published a joint Key Aspects document which highlights the key features of the new legislation in those territories. This article is based on the new rules in those territories, although the substance of the legislation introduced in other territories is broadly the same.

The legislation is a result of the assessments made by the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes, and a detailed review by the EU Code of Conduct Group of over 90 jurisdictions, focusing in particular on tax transparency, fair taxation, and compliance with anti-BEPS (Base Erosion and Profit Shifting) measures.

ECONOMIC SUBSTANCE REQUIREMENT

The legislation requires certain companies to show that they have substance in the territory by:

- Being directed and managed in the territory;
- Conducting Core Income Generating Activities (CIGA) in the territory; and
- have adequate people, premises and expenditure in the territory to support those activities.

WHICH COMPANIES ARE CAUGHT

The legislation applies to companies whose activities were identified by the OECD's Forum on Harmful Tax Practices, as being of particular interest to them. These are:

- Banking
- Insurance
- Shipping
- Fund management (except Collective Investment Vehicles)
- Financing and leasing
- Headquarters

- Distribution and service centres
- Holding companies
- Intellectual property (for which there are additional specific requirements)

All tax resident companies will have to provide information in their tax returns to ensure that these "relevant activities" can be identified, and that compliance with the rules can be monitored.

IP COMPANIES

Intellectual property companies are in a special category, where a company will need to consider whether it is a "high risk IP company". For IP companies holding patents, its CIGA is expected to include R&D activities, and for non-trade intangibles such as brands, it is expected that its CIGA would include marketing and distribution activities. Periodic decisions by non-resident directors, or local staff passively holding intangible assets will not be sufficient to demonstrate CIGA for IP.

A high risk IP company will need to provide additional evidence of its activities in the territory such as:

- Detailed business plans which set out the commercial rationale for holding IP in that jurisdiction;
- Clear evidence of local decision making;
- Full information on local employees, including experience, qualifications, terms of engagement.

DIRECTED AND MANAGED

The requirement that companies carrying on relevant activities are directed and managed in the territory is separate from the management and control test to determine residence. There needs to be sufficient local board meetings. The test will ensure that minutes and records are kept in the territory, and that the board is a decision taking body with requisite knowledge and experience.

CORE INCOME GENERATING ACTIVITIES (CIGA)

CIGA are the essential and valuable activities that generate income for the company. The CIGA need to be appropriate to the company in question, and requirements will depend on the company's purpose.

OUTSOURCING

CIGA can be outsourced, but the company must be able to demonstrate that it has adequate supervision of the outsourced activities. Where activities are outsourced the local resources of the service provider will be considered, to ensure that people and premises tests are met.

REPORTING REQUIREMENTS

Reporting will be made as part of the company's income tax filing, and will cover all the key requirements of the legislation. This will require submission of detailed information about how the company does business in the territory.

SANCTIONS AND INTERNATIONAL REPORTING

There are significant sanctions and penalties for failing to comply with the substance requirements and with the reporting requirements. They are on an escalating scale, but in the Crown Dependencies the financial penalties can reach £100,000, with the ultimate sanction of striking the company from the Companies Register. Penalties in BVI can be up to \$400,000 for repeated failure by a high risk IP company, and ultimately striking from the Register.

There will also be an automatic exchange of information with the jurisdiction in which the holding company or ultimate beneficial owner is resident.

NEXT STEPS

Any company based in affected jurisdictions will need to consider whether they can meet the economic substance test relevant for that territory. Groups with companies in those territories that carry on affected businesses will need to consider first of all whether they comply, and if they do not, what steps could be taken to enhance the activities carried on in the territory so that they can comply. Finally, they may need to consider relocating activities carried on by companies that cannot meet the economic substance test.

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