

Offshore Economic Substance Rules



In this issue, we provide an overview of the offshore economic substance requirements recently introduced by a number of low or no tax jurisdictions. Groups with entities in jurisdictions such as the Cayman Islands, British Virgin Islands ('BVI'), Bermuda, Jersey, Guernsey, Isle of Man, Bahamas, United Arab Emirates, Barbados and Mauritius need to assess whether they fall within the scope of the new rules as soon as possible, as the requirements can apply to new entities from 1 January 2019 and to existing entities from 1 July 2019.

Background

In December 2017, in conjunction with the OECD work on countering harmful tax practices under the Base Erosion and Profit Shifting ('BEPS') program, the European Union ("EU") Code of Conduct Group ('CCG') released a blacklist of non-cooperative jurisdictions. This followed a review covering the areas of tax transparency, fair taxation and implementation of anti-BEPS standards. The criterion on fair taxation stated that a jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction. The original blacklist included

17 non-cooperative jurisdictions, but this was reduced to 11 jurisdictions¹ in the most recent list issued by the CCG (June 2019) following actions by some of the listed countries to address the EU's concerns.

Overview of Economic Substance Requirements

In response to the OECD and EU reports, several jurisdictions² have introduced economic substance laws. While each jurisdiction has introduced its own legislation and guidance, the key requirements are broadly similar across jurisdictions (as they are based on the recommendations made by the OECD and the CCG).

Relevant Entities and Activities

The economic substance rules apply to “relevant entities” that carry on “relevant activities”. Relevant entities are generally defined as follows:

- locally incorporated / registered companies;
- foreign companies registered in relevant jurisdictions; and
- limited partnerships;

which carry on “relevant activities” in an offshore jurisdiction and that are not tax resident in another jurisdiction.

Relevant activities generally comprise the following types of business:

- Banking
- Distribution and service centres
- Finance and leasing
- Fund management
- Headquarters
- Holding company
- Insurance business
- Intellectual property holding
- Shipping

The economic substance that needs to be established and maintained in respect of the relevant activities in the relevant offshore jurisdiction focus on the following criteria:

- i. Adequate physical presence;
- ii. Adequate full time employees with suitable qualifications (this can be outsourced to third party service providers within the offshore jurisdiction);
- iii. The entity must be managed and directed in the offshore jurisdiction;
- iv. Core income generating activities are undertaken with respect to the relevant activity; and
- v. Adequate operating expenditure is incurred.

The core income generating activities (referred to as “CIGA”) are listed in each countries’ regulations and vary depending on the type of business. For example, a fund management business may be required to undertake investment and hedging decisions and prepare

reports or returns. Whereas a shipping business may be required to manage crew, maintain ships and oversee and track deliveries. The list of CIGA is neither exhaustive nor mandatory; rather they provide guidance on the types of activities that would indicate substance.

There are certain exceptions to these general economic substance requirements for:

- Holding companies³ which would only be required to meet a reduced test for economic substance (e.g. items (i) and (ii) above).
- Intellectual property companies have stricter requirements and are presumed not to have met the economic substance test unless sufficient information in respect of control over the intangible asset and adequate qualified employees is provided to rebut this presumption.

Whilst not strictly following the EU economic substance recommendations, the Financial Service Commission of Mauritius (“FSC”) also released a circular in October 2018 providing guidance on the enhanced Substance Requirements for Global Business License Companies (“GBLs”) and clarity on the definition of core generating activities of the GBLs, including the employment of qualified persons and a minimum level of business expenditure.

The list of countries introducing economic substance rules is likely to increase over the next 12 months as further countries seek to meet the EU’s requirements.



1. American Samoa, Belize, Fiji, Guam, Marshall Islands, Oman, Samoa, Trinidad and Tobago, United Arab Emirates, US Virgin Islands and Vanuatu.
2. Cayman Islands, British Virgin Islands ('BVI'), Bermuda, Jersey, Guernsey, Isle of Man, Bahamas, United Arab Emirates, Barbados and Mauritius
3. Holding company is defined differently in some jurisdictions but in most of the jurisdictions (e.g. Cayman Islands, BVI) it is defined as a pure equity holding company that only derives income by way of dividends and capital gains.

Reporting Requirements

The Economic Substance laws require entities resident/registered in the affected jurisdictions² to file an annual economic substance declaration with the designated authorities of those jurisdictions, with the first reporting due in 2020. Notification requirements can exist even for entities that do not fall within the rules.

Penalties on Non-Compliance

To ensure that the companies comply with the economic substance requirements, there are penalties for entities that are in breach of the economic substance requirements. These vary in each of the jurisdictions, but can include:

- fines generally ranging from USD 10,000 for the initial year and USD 100,000 for non-compliance in subsequent years;
- penalties for failure to provide incorrect information, including monetary penalties and imprisonment; and
- automatic exchange of information from the annual economic substance declaration with EU member states where the owners are incorporated, formed, registered, or resident.

Economic Substance and the Funds Industry

Carve-out for investment funds

Some of the more popular fund-domiciliation

jurisdictions such as the Cayman Islands and the BVI have specifically carved out investments funds from the scope of the economic substance requirements.

However, investment managers who are licensed and tax resident in these locations can fall within the ambit of the economic substance rules. Fund managers should also be aware that licensing requirements may have also changed (for instance, Cayman fund management entities that used to be excluded from relevant the licensing requirements will now have to register with the Cayman Islands Monetary Authority (CIMA) by 15 January 2020).

How we can help

As the economic substance rules are already in operation, an assessment of the impact on any entities you have in the affected jurisdictions should be made as soon as possible to mitigate penalties. The analysis of whether the rules apply may not be as straightforward, even for holding companies. If substance requirements are not able to be met, options such as the changing of tax residency or re-domiciliation to another jurisdiction such as Singapore should be considered.

We welcome the opportunity to discuss the impact of these changes on your business and possible mitigation strategies.



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