The economic substance test

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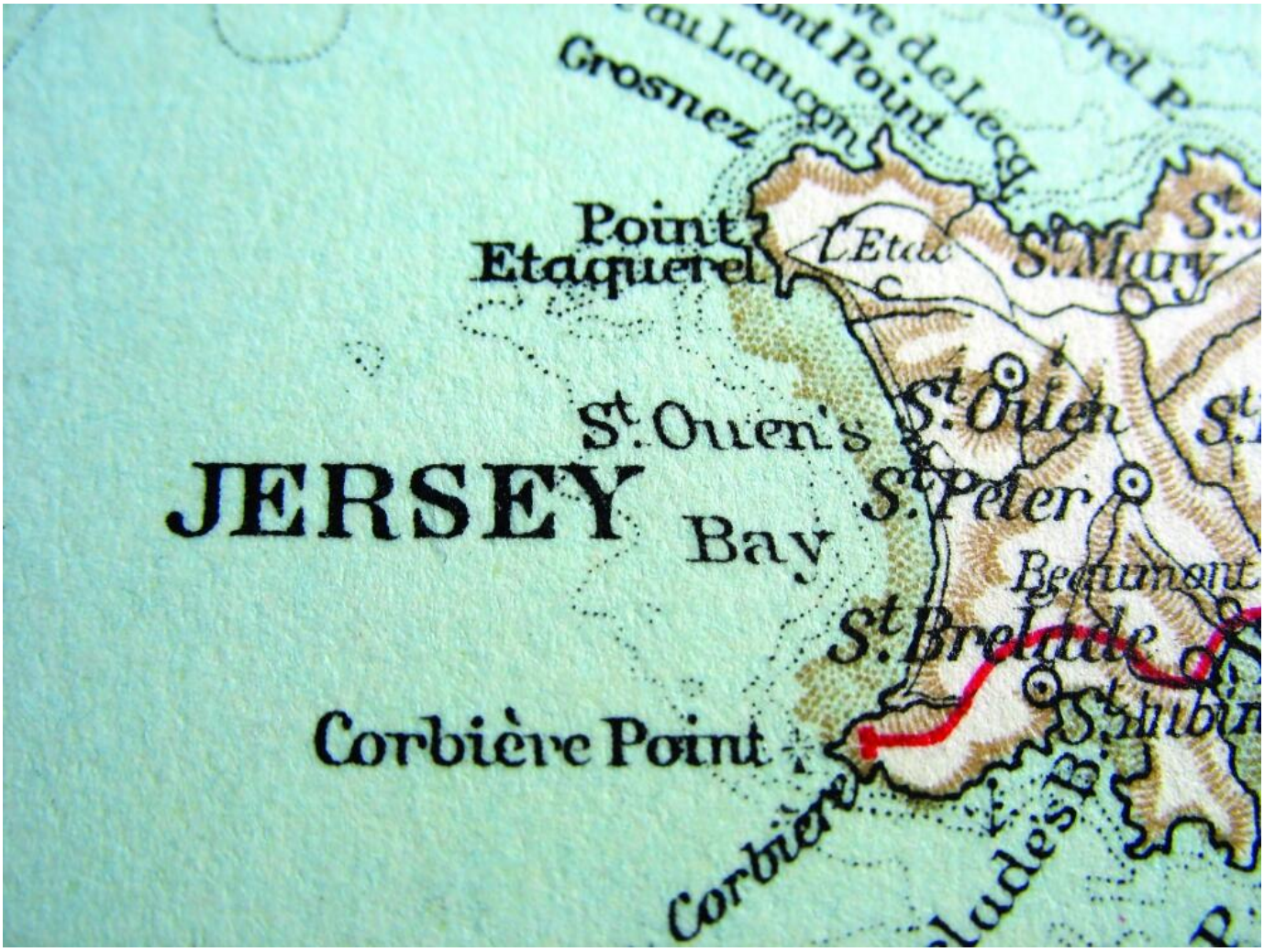

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Harriet Brown considers the impact of the economic substance test on Crown dependencies a year after its introduction

Key Points

What is the issue?

On 22 November 2019, Guernsey, Jersey and the Isle of Man (the ‘Crown dependencies’) introduced further additions to their joint guidance on legislation, requiring companies resident in the islands to demonstrate ‘economic substance’ sufficient to comply with EU rules.

What does it mean for me?

These substance requirements have now been in effect since 1 January 2019 and, a year on, the guidance issued by the Crown dependencies has been updated on a number of occasions.

What can I take away?

Financial penalties will be charged in respect of each period in which the company fails to meet the economic substance requirements, and will increase in cases of repeated periods of failure. Striking off is the ultimate sanction and is only applied in cases of repeated failure.

The broader background to the economic substance test is the Inclusive Forum Project to tackle base erosion and profit shifting (BEPS), supported by the OECD secretariat, which resulted in the Multilateral Conventi on to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (‘MLI’). The BEPS Action Plan identified 15 actions to address BEPS in a comprehensive manner, and set out deadlines to implement those actions. BEPS Action 5 addressed ‘Countering harmful tax practices more effectively, taking into account transparency and substance’.

This included ensuring that – in accordance with the second pillar of the BEPS project – taxation is actually aligned with substance; i.e. the aim is that it should no longer be possible for taxable profits to be artificially shifted away from the countries where value is created.

On 22 November 2019, Guernsey, Jersey and the Isle of Man (the ‘Crown dependencies’) introduced further additions to their joint guidance on legislation, requiring companies resident in the islands to demonstrate ‘economic substance’ sufficient to comply with EU rules. The guidance was previously last updated in April 2019.

In 2016, the EU Council committed to coordinated policy efforts in the fight against tax fraud, evasion and avoidance; and adopted the ‘Conclusions on criteria and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes’. The Code of Conduct Group was then instructed by the EU Council to undertake a screening process whereby jurisdictions (including the Crown dependencies) were assessed against three standards in respect of:

- tax transparency;
- fair taxation; and
- compliance with anti-base erosion and profit shifting (BEPS) measures.

A concern was raised that the lack of a substance requirement ‘increases the risk that profits registered in a jurisdiction are not commensurate with economic activities and substanti al economic presence’.

Identical concerns were raised in relati on to all of the Crown dependencies. Consequently, they worked together to develop legislation to address the concern of the Code of Conduct Group. They also developed the common guidance.

The legislation in each jurisdiction requires companies tax resident therein to demonstrate that they have sufficient substance (to be shown by undertaking certain activities). The legislation in each case is:

- Income Tax (Substance Requirements) (Implementation) Regulati ons 2018 (Guernsey);
- Income Tax (Substance Requirements) Order 2018 (Isle of Man); and
- Taxation (Companies – Economic Substance) (Jersey) Law 2019.

These substance requirements have now been in effect since 1 January 2019 and, a year on, the guidance issued by the Crown dependencies has been updated on a number of occasions. It is a good time to reflect on their implementation in practice.

The essence of the economic substance test in the Crown dependencies

The substance test is relevant to all companies resident for tax purposes in the Crown dependencies and for accounting periods commencing on or after 1 January 2019.

The legislation addresses the concern that companies could be used to shift profits to the Crown dependencies that are not commensurate with their economic

activities and substantial economic presence there. With the aim of counteracting this, companies are required to demonstrate that they have substance in the relevant Crown dependency by:

- being directed and managed in the island;
- conducting core income generating activities in the island; and
- having adequate people, premises and expenditure in the island.

Substance requirements do not apply to all companies, but are required for companies with income from ‘geographically mobile financial and other service activities’.

All the activities to which the requirement applies are identified by the OECD’s Forum on Harmful Tax Practices, and include:

- banking;
- insurance;
- shipping;
- fund management (except collective investment vehicles);
- financing and leasing;
- headquarters;
- distribution and service centres; z{holding companies; and
- intellectual property (where there are additional requirements in scenarios considered ‘high risk’).

Directed and managed in the island

Being ‘directed and managed in the island’ is distinct from the residency test of ‘management and control’.

The aim of the directed and managed test is to ensure that there are an adequate number of board meetings held and attended in the relevant Crown dependency to show that the company has substance. This requirement does not need all meetings to be held in the relevant Crown dependency, however.

There is no specific number of meetings that will constitute an ‘adequate number’ (adequate number is not defined – see further below). This may vary, depending on which of the relevant activities a company undertakes. As a general rule, a majority of board meetings should be held in the relevant Crown dependency. Companies

with a minimal level of activity (e.g. holding companies) should hold at least one meeting of the board of directors in the relevant Crown dependency to meet the standard recommended by the guidance.

Another element of the directed and managed test is record keeping. This part of the test ensures that a company's minutes and records are kept in the island, but also (and perhaps more importantly) that the board is both a genuine decision-taking body and that the board members have the necessary knowledge and experience. While this test is not the same as the managed and controlled test for residency, there is a clear analogy with UK case law on residence, where the board of directors has not genuinely taken decisions.

Core income generating activities

These are the essential and valuable activities that generate the income of the company. For each sector subject to the substance test, the legislation in each Crown dependency provides a list of the core activities a company operating in such a sector could carry on. This does not mean that it is necessary for a company to undertake all of those activities; however, it seems probable that some of them must be being undertaken in the relevant Crown dependency.

The guidance contains extensive guidance on this area, including a large number of examples. While examples are, of course, helpful, these should be adopted with caution. Where the fact pattern is similar but different, it is probable that the example cannot
be relied upon. Where a company has corporate directors, the requirements will apply to the officers of the corporate director who actually perform the duties of a director in relation to the company in question.

This requirement does not mean that a company cannot outsource some or all of its activities, which can include outsourcing, contracting or delegating to third parties or group companies. There are stringent requirements for outsourcing, however. If some or all core income generating activities are outsourced, it must be demonstrated that the company has 'adequate' supervision of the outsourced activities and that those activities are undertaken in the island.

For a core activity that is outsourced, the resources of the service provider in the island are 'counted' when determining whether the people and premises test (see below) is met, but there must be no 'double counting' of those resources; for

example, where the services are provided to more than one company.

In the context of outsourcing, the company remains responsible for accurate reporting. This includes precise details of the resources employed by its service providers (consequently timesheets should be used by any outsourced service provider).

People, premises and expenditure

Unfortunately, the guidance does not address this element of the test in any detail.

Updated guidance

The guidance was updated on 22 November 2019. The updated guidance addresses the following issues. First, collective investment vehicles (CIVs) regulated in the territories are out of scope of the legislation. The guidance now explains: ‘CIVs are out of scope if they are subject to regulation in the island. However, subsidiaries of a CIV will have to ensure they meet the substance requirements in relation to any relevant activities.’

The guidance also now deals with cell companies. Cell companies are either protected cell companies (PCCs) or incorporated cell companies (ICCs). Whilst both are subject to the economic substance requirements (when they have income from a relevant activity), due to the different nature and structure of the two types of entity the application of the regime to each is slightly different.
A PCC is a single legal entity (as opposed to an ICC, where the cells are separate entities to the cell company itself – see below). The tax treatment in the relevant Crown dependency will reflect these differences and consequently the substance test applies differently. Thus, a PCC is required to satisfy the economic substance requirements at what the guidance refers to as a ‘whole entity level’. This includes the activities and resources of all its protected cells, so that each cell must demonstrate that it conducts core income generating activities in the island.

A protected cell is not a corporate body and so each cell’s activities and resources form part of the overall substance information to be reported by the PCC. A protected cell is not required to report any economic substance requirements on its own account.
In relation to ICCs, both the ICC and each of its cells is a separate legal entity (an ICC cell is itself incorporated). The ICC only has to satisfy the economic substance test in

relation to any activities it conducts itself; it does not have to satisfy, or report, in relation to each of its cells. However, each cell will have to satisfy the economic substance test in its own right and in relation to its own resources without reference to those of the other cells or the cell company.

The updated guidance also contains further details on insurance, shipping, intellectual property companies and high-risk intellectual property companies.

Perhaps most importantly, it gives further guidance on sanctions for failing to meet the economic substance requirement in an accounting period. These sanctions include exchange of information with competent authorities in other jurisdictions, financial penalties and, ultimately, being struck off the companies register. Exchange of information with competent authorities in other jurisdictions will take place in respect of each period that the company fails to meet the economic substance requirement. This is a potentially significant sanction, because it could result in a change of residency status in the other jurisdiction, and consequently significant tax charges and penalties (for the company, its parent or ultimate beneficial owners).

Financial penalties will also be charged in respect of each period in which the company fails to meet the economic substance requirements, and will increase in cases of repeated periods of failure. Striking off is the ultimate sanction and is only applied in cases of repeated failure.

The economic substance test is here to stay. The guidance is a helpful tool in interpreting it and note should be taken of the guidance and any updates to it, particularly in light of the serious nature, and repercussions, of the sanctions available within the Crown dependencies.