CLIENT ALERT

Potential New Local Economic “Substance” Requirements for Companies in Jersey, Guernsey, Bermuda, the Cayman Islands and the Isle of Man, to Take Effect in January 2019

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Companies formed in Jersey will have to comply, for tax purposes, with enhanced local “substance” requirements, with effect from 1 January 2019. Similar legislation may come into force in Guernsey, the Isle of Man, Bermuda and the Cayman Islands.

In December 2017, the European Union (“the **EU**”) Code of Conduct Group (Business Taxation) (the “**COCG**”) issued a list of non-cooperative tax jurisdictions. Most countries were keen to avoid this potential “blacklisting” and therefore undertook to change the potentially harmful characteristics of their tax regimes that had been identified by the COGC, in accordance with the COCG’s guidelines and timetable. Where such an undertaking was given, the jurisdiction was deemed to be provisionally cooperative and was effectively held on an interim “grey list”.

The COCG’s analysis is based on the final report issued by the OECD in October 2015, pursuant to Action 5 of their Base Erosion and Profit Shifting initiative, regarding the countering of harmful tax practices more effectively, taking into account transparency and substance (the “**Final BEPS Report**”).

One characteristic considered by the COCG, under the “fair taxation” heading, was whether the jurisdiction in question has a tax system that facilitates offshore structures by attracting profits without commensurate economic activity.

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Bermuda, the Cayman Islands, Guernsey, the Isle of Man and Jersey were identified, in the light of their zero or almost zero nominal corporate tax rates, as having fallen short of necessary substance requirements in this respect. In response, they each committed to introduce substance requirements into local law by 31 December 2018.

The governments of Jersey and Guernsey and the Isle of Man (the “**Crown Dependencies**”) have been collaborating on their responses and, in August 2018, Jersey and Guernsey released public consultation documents regarding the measures they proposed to take.

The new local economic substance measures are intended to apply to certain businesses that have been identified as having “geographically mobile income”, including banking, insurance, fund management and holding company activities.

According to the consultation documents, it is proposed that from 1 January 2019, a company carrying on any such a business and tax resident in a Crown Dependency will be required to show it has sufficient local substance commensurate with its profits, tested by reference to three requirements.

The first requirement relates to local direction and management of the company: board meetings must be held within the jurisdiction at an “adequate frequency” given the level of decision-making required; a quorum of directors must be physically present at the meetings; strategic decisions must be taken at those meetings and recorded in board minutes; all company records must be kept within the jurisdiction; and the board of directors must have the necessary knowledge and expertise.

The second requirement is that the company’s core income-generating activities must take place within the Crown Dependency, whether carried on by the company itself or outsourced to a third party.

What counts as a core activity depends on the nature of the business. Consistent with the Final BEPS Report recommendations, the core activities for some of the affected financial and service businesses are identified as follows:

- **fund management** – taking decisions on holding and selling investments, calculating risks and reserves, taking decisions on interest and currency fluctuations and hedging discussions, preparing reports for government, regulators and investors;

- **insurance** – predicting and calculating risk, insuring and reinsuring risk and providing client services;

- **holding company** – meeting corporate law filing requirements, having the substance necessary to hold and manage shares.

The third requirement is that there must be an “adequate level” of qualified local employees (or an adequate level of expenditure on outsourcing to service companies with local employees), an “adequate level” of locally incurred annual expenditure (either internally or on outsourcing to a local service provider), and adequate physical office accommodation located in the jurisdiction. “Adequate” is judged according to the needs of the company’s activities.

There is a useful acknowledgement that the requirements should be applied with a light touch to collective investment vehicles.

For holding companies that are already observing typical guidelines to avoid becoming inadvertently resident in the United Kingdom under the “central management and control” test, the first requirement may sound rather familiar, and the incremental burden of complying with it may be minimal. Having said that, boards of holding companies that in the past may have held meetings in a number of different jurisdictions would now need to commit to meeting principally (or perhaps solely) in the home Crown Dependency. To date, the governance guidelines may have set only a minimum target of not holding board meetings in the UK and may have only recommended, rather than required, that all board meetings be held in the jurisdiction of incorporation.

For insurance companies (and banks), applicable regulatory requirements may already effectively ensure that the second and third requirements are met. In addition, existing operational guidelines, which seek to reduce the risk of the company inadvertently falling within the scope of a full-tax jurisdiction on the basis that it is trading there through a permanent establishment (or other similar basis, such as the United Kingdom diverted profits tax charge), may also already effectively ensure that there is a certain level of local substance and that core profit-generating activity takes place in the company’s jurisdiction of incorporation.

However, one area which may need to be addressed is outsourcing.

The BEPS Final Report draws a distinction between outsourcing to related versus unrelated parties and seems to accept that there may be no need to impose any legal controls on the level of outsourcing to unrelated persons on the basis that such an arrangement should be self-policing because a business would not outsource any element of the fundamental value-creating activity without itself engaging in substantial activity to supervise and manage the outsourced tasks. On the other hand, the BEPS Final Report is much more hesitant about outsourcing to related parties.

In contrast, the Jersey consultation document appeared to take a more tolerant stance in relation to outsourcing to related parties (in that it does not appear to draw a distinction between outsourcing to related and unrelated parties) but is concerned about the distinction between local and non-local service providers. The proposals seem to insist on outsourcing to *local* service providers. It is unclear how these requirements impact common structures, involving service provision by, or delegation to, persons outside the Crown Dependency. For example, an asset manager may engage an affiliate located in a full-tax jurisdiction to provide investment research services, whilst reserving to itself the ultimate discretionary fund management decision-making, or, an insurance company may benefit from marketing services provided by an affiliate in another jurisdiction.

All companies affected by these new rules will be required to include information regarding substance on their tax returns and, potentially, face audits of their behaviour. The consultation papers indicate that the sanctions for non-compliance would include financial penalties for failure to meet substance requirements, and spontaneous exchange of information with the tax authority of the EU member state in which the company's parent entity is located. Persistent non-compliance could result in the company being struck off the register of companies.

Both the Guernsey and Jersey consultations have now closed, and the Jersey government published draft legislation on 23 October 2018, accompanied by a promise to publish official guidance notes, to explain how the legislation will operate in practice, by 5 November 2018. Neither Guernsey or the Isle of Man have yet confirmed the scope of their new rules or provided draft legislation. The commitment by the Crown Dependencies to implement substance rules for the 2019 year of assessment leaves very little time for businesses to take stock of the new regime.

In the meantime, we wait to see whether Bermuda and the Cayman Islands plan to introduce similar measures or if they are able to agree less onerous requirements with the COCG. Similar substance requirements could have a material impact on the Cayman Islands (and the businesses that are based there), as exempted companies are required to carry out their operations mainly outside the Cayman Islands.

If any of these jurisdictions fail to respond to the COCG's satisfaction and are reinstated on the EU list of non-cooperative jurisdictions, EU member states will be encouraged to introduce defensive measures to protect their tax base. Suggested measures include reinforced monitoring and audit, non-deductibility of costs represented by payments to companies in such jurisdictions or withholding on payments to companies in such jurisdictions, the application of CFC rules in relation to subsidiaries in such jurisdictions and limitations on any participation exemption in relation to returns on shareholdings in companies formed in the blacklisted jurisdiction.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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