

# THE NATIONAL LAW REVIEW

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## The Economic Substance Requirements

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In order to address concerns raised by the EU Code of Conduct Group, a number of jurisdictions have recently taken steps to meet the European Union's tax good governance principles by introducing "substance" rules for companies that are resident, and carrying on certain activities, in their jurisdictions. Any companies in these jurisdictions should take urgent steps to ensure they are compliant.

### IN DEPTH

As part of its remit, the EU Code of Conduct Group undertook a review of a number of jurisdictions' tax policies. The review identified concerns with the lack of statutory "substance" requirements in the British Virgin Islands (BVI), Cayman Islands, Bermuda, Jersey, Guernsey, and the Isle of Man, which were thought to increase the risk of profits attributed to companies in those jurisdictions not reflecting the activities carried on there.

To alleviate these concerns, new legislation became law in the various jurisdictions from 1 January 2019. There are some incongruities between the rules as applied in the jurisdictions, and some differences in implementation periods and readiness.

### Application

Although the terminology differs slightly amongst the six jurisdictions, the respective legislation applies generally to companies that are "resident" in one of these jurisdictions and carry on a "relevant activity".

To determine whether or not a company is resident for the purposes of the new requirements, reference must be made to the appropriate corporate law or tax legislation in the applicable jurisdiction.

The list of relevant activities is mirrored across all six jurisdictions and covers the following sectors:

- Banking
- Insurance
- Fund management Financing and leasing
- Headquarters
- Shipping
- Holding
- Intellectual Property
- Distribution and Service Centre

It is still unclear whether or not private trust companies (PTCs) fall under the new regulations. As the primary function of a PTC is to act as trustee and to hold the trust assets, it arguably does not produce any gross income in respect of a relevant activity. There has been no definitive confirmation from any of the jurisdictions yet; however, it is anticipated, for example in Jersey, that PTCs will be excluded from the new regulations within subsequent guidance.

### The Economic Substance Test



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To fulfil the economic substance requirements, a resident company carrying on a relevant activity must comply with the following broad criteria in the appropriate jurisdiction.

### *Physical Presence*

The physical presence of a resident company and its personnel is considered the most important criteria, but it is not restricted to having an office, premises, and/or plant and machinery located in the jurisdiction.

A company can be classified as having a physical presence if it has an “adequate” number of employees physically present. The employees must also have the appropriate level of knowledge and skills for the company’s activities. Companies will need to carry out a detailed analysis of its personnel, from senior executive level down.

Similarly, an “adequate” operating expenditure incurred in the jurisdiction, proportionate to the level of the relevant activity, is also imperative.

Unfortunately, there is no statutory definition of “adequate” within the legislation, and guidance remains sparse.

### *Directed and Managed*

The “directed and managed” requirement is very broad and is satisfied by having board meetings conducted in the relevant jurisdiction at regular intervals, with a quorum of directors physically present. The directors should have specific knowledge of the relevant industry in order to discharge their fiduciary duties. All key, strategic, and risk management decisions should be made at the board meetings and carefully documented, as minutes will need to be produced. It is recommended that the company records, which includes board minutes, be kept at the companies’ premises in the jurisdiction.

### *Core Income-Generating Activities*

These are activities that are central to the resident company and so vary between sectors. For example, the core income-generating activities in a company active in banking will be different to those expected in a shipping business.

These core income-generating activities are vital, as they identify which activities are seen by the relevant jurisdiction as necessary to carry out work in a particular sector. It is, however, possible to outsource some of these actions and a non-exhaustive list for each qualifying activity can be found within the relevant legislation.

Holding companies largely benefit from reduced requirements. Intellectual property companies have, however, been singled-out with a higher substance threshold.

## **Impact**

The new economic substance requirement legislation became applicable to all newly established resident companies on 1 January 2019. Some of the jurisdictions have provided a transition period for existing entities, which is typically six months.

The ongoing obligations differ greatly. For example, in Jersey, Guernsey, and the Isle of Man, additional information will need to be included within the annual corporate tax returns. In contrast, the Caribbean localities require that separate, annual accounts be filed with the relevant tax authority. In some cases, such as in the Cayman Islands, the relevant company will need to demonstrate how the economic substance requirements are being met.

It seems that the information gathered by the tax authorities for the economic substance requirements may also be used for ancillary purposes. In the BVI, for example, the details will be used to update and monitor their Beneficial Ownership Secure Search System, which tracks beneficial ownership. The other jurisdictions have similar beneficial registers, but it is not yet clear how they will process information. In all jurisdictions, the penalties for non-compliance range from fines to imprisonment, and repeated failure to observe these new requirements will result in the resident company being struck off.

It is also possible for information to be disclosed to any jurisdiction in which the immediate parent company, ultimate parent company, and/or ultimate beneficiary is/are resident.

## **What’s Next?**

The legislation is already in force in the six jurisdictions, but there are still questions about how to interpret some of the requirements. More detailed guidance is likely to become available in each of the jurisdictions shortly.

In the meantime, any companies already established in one of the jurisdictions should be reviewed to see if they are potentially caught and, if so, steps should be taken over the coming weeks to meet the requirements.

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