Substance Requirements

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Substance Requirements

The EU, following the work of the EU Code of Conduct Group, obtained commitments from the so called 2.2 jurisdictions to implement substance requirements for companies undertaking relevant activities. The 2.2 jurisdictions include amongst others Anguilla, Bahamas, Bahrain, BVI, Cayman, Guernsey, Isle of Man, Jersey, Marshall Islands, Turks & Caicos Islands and United Arab Emirates (Dubai).

The jurisdictions are at different stages in honouring these commitments to introduce substance requirements for relevant companies for accounting periods commencing on or after 1st January 2019.

The Crown Dependencies of Jersey, Guernsey and the Isle of Man have been working together jointly with the EU and have now published a summary 'Key Aspects' document and legislation for each jurisdiction. Joint Guidance is also expected to be published shortly.

The Key Aspects document and the relevant draft legislation can be found via the links below:

https://www.gov.im/media/1363453/key-aspects-in-relation-to-proposed-economic-substance-requirements-issued-jointly-by-guernsey-isle-of-man-and-jersey.pdf

Jersey
https://statesassembly.gov.je/assemblypropositions/2018/p.132-2018%20with%20corrig.pdf

Isle of Man
https://www.gov.im/media/1363452/draft-isle-of-man-legislation-income-tax-substance-requirements-order-2018.pdf

Guernsey
https://www.gov.gg/CHttpHandler.ashx?id=116235&p=0

Overview of the requirements under the Crown Dependency Legislation

It applies to companies for accounting periods commencing on or after 1st January 2019 with income from a relevant sector. The relevant sectors are:

- Banking
- Insurance
- Shipping (this does not include yachts)
- Fund management (but not the fund entities)
- Financing and leasing (excludes leasing of land or interests in land)
- Headquartering
- Operation of a holding company (owning more than 50% of subsidiaries)
- Holding intangible property ("IP")
- Distribution and service centre business

Relevant sector companies will be required to make appropriate disclosures annually to demonstrate that they have met the substance requirements by having adequate substance in the jurisdiction of the company.

There is a rebuttable presumption that high risk IP companies will fail the substance requirements and will have higher thresholds to meet to demonstrate adequate substance and will also be subject to automatic annual reporting by the local fiscal authority to the relevant EU jurisdiction where there is an ultimate EU parent company or an EU ultimate beneficial owner. A high risk IP company is either one that (a) owns an IP asset that (i) has been acquired from related parties or obtained through the funding of overseas research and development activities; and (ii) is licensed to related parties or monetised through activities performed by foreign related parties or (b) an IP company that owns an IP asset and does not carry on research and development or marketing, branding and distribution in the jurisdiction of the company.

The substance requirements will apply to all relevant sector companies irrespective of whether or not there is any EU ownership or EU activities or assets.

There are penalties for non-compliance including ultimately the company being struck off.

Substance requirements

The substance requirements will vary depending on the actual activity, but in summary will generally be that;

- It is directed and managed in the jurisdiction
- There is an adequate number of qualified employees in the jurisdiction
- It has adequate expenditure proportionate to the level of activity carried on in the jurisdiction
- It has adequate physical presence in the jurisdiction
- It conducts core income-generating activity in the jurisdiction

For a pure equity holding company the substance requirements will be met if the company complies with its statutory obligations and has adequate people and premises for holding and managing the equitable interests or shares.

Activities can also be outsourced to other parties in the same jurisdiction.

Our understanding is that where relevant companies are wound up in the first accounting period where the substance rules apply no additional substance will be necessary.

Action to be taken

- Identification of relevant sector companies that will be subject to the new rules.
- Identification of the first accounting period which will be subject to the new rules.
- Take steps to ensure that appropriate substance requirements are met and that these are documented.
- Where there are difficulties with meeting the substance requirements consideration will need to be given to what restructuring can be undertaken, eg using a company in an EU jurisdiction such as the UK, Ireland, Malta, Cyprus, Luxembourg or Netherlands or non-EU companies like Hong Kong or Singapore.

Summary

Whilst these are significant changes and will increase the level of documentation and reporting required, it is likely that most companies will either meet the substance requirements or will not be caught by the new rules. For companies unable to meet the substance requirements there will be various restructuring options. Companies likely to need particular attention will be IP companies and also companies where the only connection to the jurisdiction is incorporation and a registered office address.

Clients will be contacted in due course to discuss how the new rules will impact them, but if there are any queries in the meantime please speak to your usual SMP contact.

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