ECONOMIC SUBSTANCE EXPLAINED
INTRODUCTION TO ECONOMIC SUBSTANCE

ECONOMIC SUBSTANCE LEGISLATION CAME INTO EFFECT IN THE CROWN DEPENDENCIES AND OVERSEAS TERRITORIES ON 1 JANUARY 2019.

The legislation is designed to protect the reputation of offshore jurisdictions by ensuring that income streams from certain activities are based on actual local activity to substantiate the use of low tax jurisdictions.

Substance legislation doesn’t apply to all entities in each jurisdiction – rather, it applies to certain ‘relevant entities’ carrying out certain ‘relevant activities’. Affected entities are required to be managed and directed, to have adequate employees, expenditure and physical presence and to conduct their ‘core income generating activities’ in the local jurisdiction.

There are two key stages to establishing how an entity might be impacted by substance regulations in any given jurisdiction:

- Is the entity in scope of the new law – i.e. is the entity a relevant entity carrying out a relevant activity?
- If it is in scope, does it meet the substance requirements?

Each jurisdiction has its own subtle variances which may cause challenges if a client group has multiple entities registered in different jurisdictions.

This guide aims to outline the new substance rules and show how Estera can assist its clients with their substance concerns and requirements.

Please get in touch with us to discuss how the substance regulations impact you.

WHICH JURISDICTIONS ARE AFFECTED?

The jurisdictions that have introduced economic substance legislation are Bermuda, British Virgin Islands, Cayman Islands, Guernsey, the Isle of Man and Jersey. Mauritius is set to introduce legislation in 2020.
WHICH ENTITIES ARE AFFECTED?

EACH JURISDICTION HAS DEFINED – WITHIN ITS OWN LEGISLATION – THE LEGAL TYPE OF ENTITIES THAT WILL BE AFFECTED BY THE NEW ECONOMIC SUBSTANCE RULES.

BERMUDA

*The Economic Substance Act 2018* applies to registered entities, which means:

- Companies incorporated under the Companies Act 1981
- Companies formed under the Limited Liability Company Act 2016
- Partnerships (exempted, exempted limited or overseas) which have elected to have separate legal personality under s4A of the Partnership Act 1902

Note: Registered entities which are tax resident outside Bermuda may be classified as non-resident entities and therefore out of scope of substance requirements.

BRITISH VIRGIN ISLANDS

*The Economic Substance (Companies and Limited Partnerships) Act, 2018* applies to all BVI companies and limited partnerships (LPs) with legal personality conducting a relevant activity, unless they are considered non-resident for the purposes of the Act, and to all foreign companies and foreign LPs doing business in the BVI. There is a category of relevant activity for holding companies but this is restricted to Pure Equity Holding Companies. If a holding company fits the strict definition then it is technically in scope, but the substance test and reporting are very light which Estera will carry out for you. If the holding company does not fall within the strict definition, and it does not fall within the other types of relevant activity, then the company will be out of scope.

CAYMAN ISLANDS

*The International Tax Co-operation (Economic Substance) Law 2018* defines which Cayman entities are relevant entities. Relevant entities include most Cayman companies (such as exempted companies), Cayman LLCs, Cayman LLPs and registered foreign companies except:

- Investment funds or entities through which investment funds directly or indirectly invest or operate (excluding the ultimate investment held)
- Entities which are tax-resident outside the Cayman Islands
- Entities which are authorised to carry on business locally in the Cayman Islands as a domestic company
- Cayman-exempted limited partnerships and trusts
GUERNSEY

The Income Tax (Substance Requirements) (Guernsey) (Amendment) Ordinance, 2018 applies to a company that is tax resident in Guernsey, namely that (i) it is controlled in Guernsey or (ii) it is incorporated in Guernsey.

ISLE OF MAN

The Income Tax (Substance Requirements) Order 2018 imposes requirements on companies that are tax resident in the Isle of Man. This generally applies to all Isle of Man 2006 and 1931 Act companies. Manx Companies can be non-resident of the Isle of Man and resident elsewhere pursuant to the terms in a Double Tax Agreement.

JERSEY

The Taxation (Companies - Economic Substance) (Jersey) Law 2019 applies to all companies that are tax-resident in Jersey.

If an entity matches the legal type specified in the law it also needs to be carrying out certain relevant activities to be affected by the requirements for economic substance.
CORE INCOME GENERATING ACTIVITY

CORE INCOME GENERATING ACTIVITIES NEED TO BE CARRIED OUT IN THE JURISDICTION TO DEMONSTRATE SUBSTANCE. EXAMPLES INCLUDE:

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<th>RELEVANT ACTIVITY</th>
<th>EXAMPLES OF CORE INCOME GENERATING ACTIVITY</th>
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| Banking business  | 1. Raising funds, managing risk including credit, currency and interest risk  
                          2. Taking hedging positions  
                          3. Providing loans, credit or other financial services to customers  
                          4. Managing capital and preparing reports or returns, or both, to investors or the local authorities |
| Distribution and service centre business | 1. Transporting and storing goods, components and materials  
                                           2. Managing stocks  
                                           3. Taking orders  
                                           4. Providing consulting or other administrative services |
| Financing and leasing business | 1. Negotiating or agreeing funding terms  
                                       2. Identifying and acquiring assets to be leased  
                                       3. Setting the terms and duration of financing or leasing  
                                       4. Monitoring and revising financing or leasing agreements and managing risks associated with such financing or leasing agreements |
| Fund management business | 1. Taking decisions on the holding and selling of investments  
                                       2. Calculating risk and reserves  
                                       3. Taking decisions on currency or interest fluctuations and hedging positions  
                                       4. Preparing reports or returns, or both, to investors or local authority, or both |
| Headquarters business | 1. Taking relevant management decisions  
                                 2. Incurring expenditures on behalf of other entities in the group  
                                 3. Co-ordinating activities of the group |
| Holding company business | 1. Companies which purely hold equities will need to confirm they comply with all applicable requirements under the jurisdictional law in which it was incorporated  
                                     2. Where holding companies also conduct other relevant activities they will additionally be subject to the requirements associated with that activity |
| **Insurance business** | 1. Predicting or calculating risk or oversight of prediction or calculation of risk  
2. Insuring or re-insuring against risk  
3. Preparing reports or returns, or both, to investors or local authority, or both |
|------------------------|------------------------------------------------------------------------------------------------------------------|
| **Intellectual property business** | A. Where the intellectual property asset is a  
1. Patent or an asset that is similar to a patent, research and development or  
2. Non-trade or intangible (including a trademark), branding, marketing and distribution  
B. In exceptional cases, except if the relevant activity is a high risk intellectual property business, other core income generating activities relevant to the business and the intellectual property assets, which may include  
1. Taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income  
2. Taking the strategic decisions and managing (as well as bearing) the principal risks relating to acquisition by third parties and subsequent exploitation and protection of the intangible asset  
3. Carrying on the underlying trading activities through which the intangible assets are exploited leading to the generation of income from third parties. |
| **Shipping business** | 1. Managing crew (including hiring, paying and overseeing crew members)  
2. Overhauling and maintaining ships  
3. Overseeing and tracking deliveries  
4. Determining what goods to order and when to deliver them, organising and overseeing voyages |
MEASURING AND REPORTING SUBSTANCE

ONCE IT HAS BEEN DETERMINED THAT AN ENTITY IS A RELEVANT ENTITY AND IS CARRYING OUT A RELEVANT ACTIVITY AS DESCRIBED BY LOCAL REGULATIONS, IT HAS TO SATISFY THE APPLICABLE SUBSTANCE TEST.

The substance requirements differ depending on the type of relevant activity an entity performs.

Generally speaking, although there are exceptions, an entity that is carrying out a relevant activity will meet the substance requirements if:

- It is managed and directed in the jurisdiction
- Core Income Generating Activities are conducted in the jurisdiction
- It has an occupied physical office or premises
- There are an adequate number of employees with suitable qualifications in the jurisdiction
- There is adequate operating expenditure in relation to the relevant activity in the jurisdiction

There are more detailed criteria under each of the points above, most notably around Core Income Generating Activities and rules around outsourcing. There are also special rules for ‘high-risk IP companies’. Please get in touch with your usual Estera contact to discuss how the regulations impact your entities.

Once substance is established, the entity must file an economic substance report each year with the applicable authority in its jurisdiction.
PENALTIES FOR NON-COMPLIANCE

Penalties for failure to comply with the new substance regulations vary from one jurisdiction to another – but range from increasing fines, removal from the register through to imprisonment.

BERMUDA

Minimum of $7,500 to $250,000 for non-compliance

- Removal from the Companies Register
- Further provision has been included for the introduction of a penalty of $10,000 or two years imprisonment for any person who fails to provide information requested by the Comptroller

BRITISH VIRGIN ISLANDS

- Minimum of $5,000 to $50,000 for non-compliance
- Any subsequent failure can increase to a fine of $10,000 to $200,000
- Removal from the Companies Register
- Further provision has been included for the introduction of a penalty of $40,000 or two years imprisonment for any person who fails to provide information requested by the Comptroller

CAYMAN ISLANDS

- Initial non-compliance penalty of $12,200
- Subsequent non-compliance penalty of $122,000
- Removal from the Companies Register
- Further provision has been included for the introduction of a penalty of $12,200 or five years imprisonment for any person who provides false or misleading information to the Tax Information Authority

GUERNSEY

- Maximum of £10,000 for initial non-compliance in accounting periods 1 and 2
- Third accounting period infraction – maximum of £50,000
- Fourth accounting period infraction – maximum of £100,000
Removal from the Companies Register
Further provision has been included for the introduction of a penalty to be levied on any person who fails to provide information requested by the Comptroller

ISLE OF MAN

- Minimum of £5,000 for non compliance
- Maximum of £10,000 for the initial non-compliance (£50,000 for high-risk IP companies)
- Any subsequent failure can increase to £100,000 per notice issued
- Further provision has been included for the introduction of a penalty of £5,000 or a custodial sentence of up to seven years for any person who provides false or misleading information to the Tax Information Authority
- Removal from the Companies Register

JERSEY

- £10,000 for the first non-compliance
- Any subsequent failure can increase to £100,000 per notice issued
- Removal from the Companies Register
- Further provision has been included for the introduction of a penalty of up to £3,000 to be levied on any person who fails to provide information requested by the Comptroller
HOW CAN OCORIAN HELP?

OCORIAN HAS A SIGNIFICANT PRESENCE IN JURISDICTIONS AFFECTED BY CHANGES TO SUBSTANCE LEGISLATION. ALONGSIDE THIS, WE HAVE COMPREHENSIVE EXPERIENCE IN GATHERING AND REPORTING COMPANY DATA IN THOSE JURISDICTIONS. AS A RESULT, WE ARE UNIQUELY PLACED TO HELP OUR CLIENTS UNDERSTAND AND RESPOND TO THE NEW LEGISLATION.

Substance determination has three stages, and based on the outcome of each stage, we are able to react accordingly. We take the following approach to dealing with substance requirements.

IS THE ENTITY IN QUESTION IN SCOPE OF THE NEW LAW?

Our experts can provide professional (non legal) advice to help you identify relevant entities conducting relevant activities.

DOES THE ENTITY MEET THE SUBSTANCE REQUIREMENTS?

We will perform a substance test on entities in scope, which may include a request for additional information from clients. The substance requirements differ depending on the type of relevant activity the entity performs. Our tests include a gap-analysis versus the requirements for adequate control, people, facilities and expenditure. Should the substance test not be met, enhanced substance may be required based on the relevant activity the entity performs.

HOW CAN THE ENTITY ENHANCE ITS SUBSTANCE?

Clients whose entities don’t meet the substance requirements will receive a proposal from us to add substance to the entity. For standard structures, solutions may be straightforward including additional corporate services or director activities. For more complex structures, we can facilitate the development and implementation of tailor-made solutions, including consideration of functions which could be outsourced to Estera.
SUBMISSIONS OF NOTIFICATIONS AND REPORTS

In some jurisdictions entities will be required to submit notifications to confirm if they are in or out of scope. In scope entities are required to file an economic substance report. We can assist in the preparation and submission of your notification and / or report in the format required by the relevant tax authority.

THE IMPORTANCE OF COMPLIANCE WITH THE NEW SUBSTANCE REGULATIONS CAN’T BE UNDERSTATED GIVEN THE POTENTIAL LIABILITY FOR EXTENSIVE PENALTIES. OUR EXPERTS CAN HELP YOU NAVIGATE THE COMPLEXITIES OF THE NEW LEGISLATION AND ENSURE THAT YOU ARE MEETING THE REQUIREMENTS.
FOR MORE INFORMATION

Damian Resnik  
Client & Operations Director  
Bermuda  
+1 441 294 8097  
damian.resnik@ocorian.com

Gareth Thomas  
Managing Director  
BVI  
+1 284 393 1301  
Gareth.Thomas@ocorian.com

Andre Slabbert  
Client Director  
Cayman Islands  
+1 345 640 0556  
andre.slabbert@ocorian.com

Mel Torode  
Managing Director  
Guernsey  
+44 1481 742 742  
mel.torode@ocorian.com

Gary O’Connor  
Managing Director  
Isle of Man  
+44 1624 605 702  
gary.oconnor@ocorian.com

Nadia Trehiou  
Client Director  
Jersey  
+44 1534 844 806  
nadia.trehiou@ocorian.com