



Economic substance requirements

Q&A

August 2019



Contents

1.	Introduction	3
2.	How are the requirements met?	3
3.	Which entities are in-scope?	3
4.	Which entities are out of scope?	4
5.	How is tax residence considered?	4
6.	What are the implications of the requirements?	5
7.	How will captured data be reported?	6
8.	Is outsourcing still permitted under the new legislation?	6
9.	How can the Aztec Group support its clients through this process?	6
10.	Which steps should clients take to analyse the rules and ensure ongoing compliance?	7
11.	How can working practices be enhanced?	7
12.	Which relevant activities are most applicable to Aztec Group clients?	8
13.	How is 'adequate' defined?	9
14.	How is 'physical presence' considered?	9

1. Introduction

In 2017, the European Union Code of Conduct Group (Business Taxation) (“**COCG**”) investigated the tax policies of non-EU countries, screening over 90 jurisdictions’ tax policies to reinforce global standards on tax matters. Guernsey, Jersey, Isle of Man, Cayman Islands, Bermuda and British Virgin Islands were some of the jurisdictions that were screened.

The COCG’s findings were largely positive. However, the COCG did indicate that the absence of a clear general statutory substance requirement increases the risk that profits registered in a jurisdiction may not be commensurate with economic activities and substantial economic presence.

In response, the governments of the Crown Dependencies and the Overseas Territories introduced economic substance legislation and guidance, which applies to all relevant entities resident in those jurisdictions with an accounting date commencing on or after 1 January 2019. These new rules and associated guidance notes need to be considered and complied with, if applicable.

This Q&A document outlines the background to the economic substance requirements, the steps that must be taken to ensure compliance, and how the Aztec Group can work with clients to assess whether any actions are necessary. It is intended to provide general guidance only and is not intended to, nor does it, constitute legal or tax advice. The precise requirements of the economic substance legislation vary between jurisdictions and are inherently fact-specific. Furthermore, this Q&A document includes certain legal terms of art that may not bear ordinary meaning. The correct interpretation of these terms is essential to ensuring that the analysis is accurate. There can be no substitute for obtaining legal advice on a case-by-case basis.

2. How are the requirements met?

At a high level, the economic substance requirements will be met if the resident company can demonstrate that:

- It is being **directed and managed** in the relevant jurisdiction;
- It has **adequate qualified people, premises and expenditure** in the relevant jurisdiction; and
- It conducts **Core Income Generating Activities (“CIGA”)** in the relevant jurisdiction.

(Collectively the “**Economic Substance Requirements**”)

3. Which entities are in-scope?

Only those resident companies that carry out one or more relevant activities will be required to meet the economic substance requirements. These relevant activities include:

- Fund management business;
- Finance and leasing business;
- Headquarters business;
- Holding company business;
- Intellectual property business;
- Distribution and service centre business;
- Banking business;
- Shipping business;
- Insurance business.

In addition, the following entities are also considered in-scope:

- A pure equity holding company;
- An intellectual property company (an “**IP company**”);
- A Protected Cell Company (“**PCC**”);
- An Incorporated Cell Company (“**ICC**”);
- An Incorporated Cell (“**IC**”).

By way of further detail, in-scope entities include those that:

- Either claim tax residency, are deemed to be tax resident, or file a tax return in those jurisdictions listed below, no matter where they have been incorporated or registered; and are Companies, Limited Liability Partnerships (“**LLPs**”), Limited Liability Companies (“**LLCs**”) and Limited Partnerships (“**LPs**”) if covered by the scope of vehicle types within that jurisdiction below;
- Undertake one or more of the defined relevant activities;
- Undertake one or more defined CIGAs in relation to their defined relevant activities.

Jurisdiction of Incorporation / Registration / Tax Residency	Entity Vehicle Type – In Scope
Jersey	Companies
Guernsey	Companies, including where a company is a partner of an LP, or LLP that undertakes a relevant activity, or derives income from intellectual property itself.
Cayman Islands	Companies, LLPs and LLCs.
Bermuda	Companies, LLCs and LPs that have opted for separate legal personality.
British Virgin Islands	Companies, LPs and Foreign Limited Partnerships (unless no legal personality).
Isle of Man	Companies.

4. Which entities are out of scope?

Certain types of entities are deliberately **not** in scope of the requirements. These include:

- Regulated funds (note the fund itself only; an SPV owned by a regulated fund and the General Partner Company are in-scope);
- LPs, LLPs and Trusts (although partners and members could be brought into scope through their activities with the LP / LLP);
- Foundations;
- Companies with no income from an in-scope activity;
- Companies that do not carry out any in-scope activity, such as property holding companies.

5. How is tax residence considered?

The tax residence of an entity must be considered.

The jurisdiction of incorporation is important, but control in that (or another) jurisdiction must also be considered, as must an entity becoming non-resident or exempt. The tax rules are complex; if an entity’s tax status is unclear, legal guidance and advice is recommended.

6. What are the implications of the requirements?

Once an entity is defined as being in-scope, there are various implications for the management of that entity. These include:

Decision making

The entity must be directed and managed from the jurisdiction in which it is domiciled / based. This means that:

- Board meetings must be held in the relevant jurisdiction at an **adequate**¹ frequency;
- Quorum must be physically present in the jurisdiction (boards should review their articles to consider if quorum is sensible);
- Strategic decisions must be taken at those meetings whilst the board is physically present in the jurisdiction;
- Minutes must record and evidence strategic decisions;
- The directors, including corporate directors, should have sufficient knowledge and / or experience; and
- All minutes and records must be kept in the jurisdiction.

Physical presence

The entity must have an **adequate**¹ level of employee, expenditure and physical presence in the jurisdiction in which it is domiciled / based. The entity must:

- Have appropriately qualified employees (this can include the employees' career experience);
- Be employed by the resident company or an administrator as a service provider ("full time equivalents" are counted, but no double-counting of staff); and
- Have a level of physical presence proportionate to the level of relevant activity carried out in the jurisdiction.

A company's directors will be included when calculating the level of employees and, as such, board directors will need to share detail of their time worked when supporting an entity, to help with submission of the new (and as yet largely undefined) tax return.

CIGA requirements

Each relevant activity highlighted in section 4 has a (non-exhaustive) list of activities that an entity conducts which are considered CIGA. These activities attract a stricter set of requirements for the decision-making body (usually the board of directors), which require the **majority to be physically present**² in the jurisdiction in which the entity is domiciled / based.

CIGA requirements include, but are not limited to:

Fund management:

- Investment decisions - holding and selling of investments (focus on strategy and decision making as opposed to execution or implementation);
- Calculating risks and reserves (includes overall risk);
- Taking decisions on currency or interest fluctuations and hedging positions (for example, whole fund position over specific decisions on single trades);
- Preparing relevant regulatory or other reports for governmental or regulatory authorities and investors (includes ensuring and overseeing systems and processes are in place if outsourcing).

¹ Please see section 13 for a definition of 'adequacy' in this context.

² Please see section 14 for a broader outline of physical presence considerations.

Financing and leasing:

- Agreeing funding terms (relates to funding of lender);
- Identifying and acquiring assets to be leased;
- Setting the terms and duration of any financing or leasing;
- Monitoring and revising any agreements (includes acquiring data);
- Managing risks.

At a high level, directors should consider the following CIGA decisions and non-CIGA decisions:

CIGA decisions	Non-CIGA decisions
Final investment decisions; Refinance decisions and loan monitoring; Risk management decisions; Approval of investor reports; Regulatory return approvals; Tax return approval.	Non-binding offers; Due diligence approvals; Investment / information only updates; Portfolio company actions; Ancillary decisions.

7. How will captured data be reported?

Alongside the new legislation, considerable changes to the tax return are being made. These changes will ensure that detailed information can be provided to the tax authorities to demonstrate that in-scope entities are meeting the economic substance requirements.

8. Is outsourcing still permitted under the new legislation?

Under the legislation, outsourcing is permitted. This is positive news for the relevant jurisdictions and for the industries that have evolved within them. However, there are some important requirements to note:

- Outsourcing must be performed in the relevant jurisdiction;
- Resources of the service provider are considered, so there is no 'double counting' of employee headcount.

The act of entering into an outsourcing contract in the relevant jurisdiction must have:

- A contractual obligation to provide regular reports / updates;
- Appropriate fees;
- Oversight (the board of the entity must demonstrate adequate supervision of the outsourced activity).

9. How can the Aztec Group support its clients through this process?

Aztec Group is approaching the economic substance requirements by taking the following steps:

1. **Internal training and information gathering** to ascertain whether an entity is in-scope;
2. **Understanding** the specific characteristics of in-scope entities;
3. **Determining** with our clients how entities meet the economic substance test;
4. **Capturing data** to account for the CIGA rules and to complete the new (and as yet largely undefined) tax return, whilst also monitoring compliance with regulations.

When determining if a client entity is in-scope of the requirements, the Aztec Group uses tools and detailed reviews to assess whether the entity:

- Is being **directed and managed** in the relevant jurisdiction;
- Has **adequate qualified people, premises and expenditure** in the relevant jurisdiction; and
- Conducts **CIGA** in the relevant jurisdiction.

Where necessary, the Aztec Group will then work with clients and legal advisors to identify and implement any actions that may be required to ensure compliance with the requirements.

If clients require new local board directors or alternate board directors, the Aztec Group can either assist directly or make introductions to local non-executive directors.

Whilst guidance has been provided, this will undoubtedly change over time. Aztec Group will remain open and prepared for changes on the subject as it evolves.

10. Which steps should clients take to analyse the rules and ensure ongoing compliance?

Clients should seek their own independent advice, which may address the following:

- Identifying the extent to which the new legislation may impact on a company's business. This may involve classifying structures on a company-by-company basis to identify those that undertake a relevant activity and, therefore, may fall within the scope of the new economic substance requirements;
- Considering current and future compliance requirements for those entities that undertake relevant activities, with respect to:
 - The "directed and managed" requirements;
 - The adequate staff, expenditure and physical assets tests; and
 - Demonstrating the existence of CIGA in the relevant jurisdiction;
- Considering how the economic substance tests will be documented and evidenced;
- Reviewing outsourcing arrangements to ensure that these do not contravene the economic substance test requirements; and
- Understanding the increased tax return disclosure requirements that will be effective as from the 2019 year of assessment. Filing dates vary by jurisdiction; clients should ensure that they are aware of the appropriate filing dates for their entities.

Please note that this is not an exhaustive list and is intended to provide examples only. A comprehensive review and analysis of the legislation pursuant to an entity structure should be undertaken by an independent advisor.

11. How can working practices be enhanced?

Examples of working practices that are compliant with the requirements include (but are not limited to):

- Physical meetings are recommended when considering matters related to the relevant CIGA instead of the use of written resolutions, as confirming that a decision has taken place in the relevant jurisdiction might be open to challenge;

- ‘Round robin’ emails between board directors should only be used for non-CIGA related activity, or to implement a CIGA decision already made within a framework agreed and documented at a board meeting held in the board’s jurisdiction of residence.
- Entity minute logs should be rebranded to ‘Substance registers’ to track points such as 1) physical attendance at meetings, 2) reportable qualifications, and 3) relevant activities at entity level;
- Boards and teams should be worked with to collate the necessary time recording data for the reporting period.

12. Which relevant activities are most applicable to Aztec Group clients?

Relevant activities that are most relevant to those entities administered by Aztec Group include:

1. Fund management business
2. Finance and leasing business
3. Holding company business
4. Intellectual property business

Considering each of these activities in turn:

Fund management business

Overview Fund management business encompasses companies which provide management services in relation to funds (such as collective investment vehicles) but does not include the funds themselves. This means that most general partner company entities to a regulated fund, that generate an income through the management fee or priority profit share, are likely to be in scope and will need to adhere to the new rules.

Finance and leasing business

Overview Finance and leasing business applies to the provision of any credit line or facility for a fee or interest (consideration) by the entity, either through originating a credit line or being assigned a credit line. Please note that an investment in a debt security, such as quoted bonds or gilts that are actively traded on a major security exchange, are not applicable under “financing and leasing” as a relevant activity and are therefore not subject to the new rules.

Holding company business

Overview A company will be regarded as a pure equity holding company if its primary function is to acquire and hold equities, and the equities in question are controlling stakes in other companies. It will be subject to the economic substance requirements if it receives income on its own behalf from those holdings (as beneficial owner of the shares). If the company also undertakes other commercial activity, then it is ‘out of scope’ for the purposes of this definition. Clients must be cautious of inadvertently falling ‘in scope’ under the relevant activity of “financing and leasing”, e.g. if a holding company was to become involved in a loan or similar arrangement.

Intellectual property business

Overview This relevant activity applies to companies that are in the business of holding intellectual property assets, including patents, copyright, trademarks, brand and technical know-how from which identifiable income such as royalties or fees accrues to the business.

NOTE: all entities conducting intellectual property business should seek independent advice in view of the rebuttable presumption that a “high risk IP company” (as defined in legislation) has failed the substance requirement, as the risks of artificial profit sharing are considered to be greater.

13. How is ‘adequate’ defined?

The term “adequate” is referred to several times in the rules and guidance notes. In aiming to define this term, the guidance states that:

"The proposed legislation refers to the term "adequate". However, this term is not defined and therefore has its ordinary meaning. The dictionary definition of "adequate" is: "Enough or satisfactory for a particular purpose".

"Given the stringent regulatory requirements in the island, which result in a significant overlap with the substance requirements, it is expected that companies carrying on banking, insurance or fund management will already be operating with adequate resources and expenditure. However, these companies will be subject to the proposed legislation (i.e. filing requirements and monitoring by the tax administration)."

14. How is ‘physical presence’ considered?

When considering physical presence and the requirement for “the majority to be physically present”, directors must be particularly vigilant, especially if a CIGA decision is added to a topic that didn’t originally require the majority to be physically present.

Boards should carefully consider their composition in light of the rules and consider alternate directors in the jurisdictions in which they are domiciled or based. Boards can also potentially appoint committees to make CIGA decisions from these jurisdictions, noting the requirements for relevant qualifications and experience.

The requirement for “the majority to be physical present” refers to the majority of those attending the meeting who count towards the quorum for the meeting, not the majority of the board as a whole. For example, if the board is comprised of five directors in total but only three attend the meeting, then two of those three will need to be physically present in the relevant jurisdiction when considering a CIGA decision.



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