Key aspects in relation to ~~proposed~~ economic substance requirements, as issued by Guernsey, Isle of Man and Jersey[1]

1 Introduction

New legislation introducing economic substance requirements for companies in the Crown Dependencies was recently approved ~~will shortly be considered~~ by the respective parliaments. This document is the first piece of guidance[2] that sets out key aspects of the ~~proposed~~ legislation and will be followed by more comprehensive guidance notes.

The ~~proposed~~ legislation is relevant to all companies resident for tax purposes in the Crown Dependencies and will be effective for accounting periods commencing on or after 1 January 2019.

Each Crown Dependency will be redesigning its tax return to ensure that all tax resident companies will be required to provide additional information concerning their activities and income.

This document should be read in conjunction with the ~~proposed~~ legislation, which can be found at:

Jersey

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

Isle of Man

https://www.gov.im/categories/tax-vat-and-your-money/income-tax-and-national-insurance/international-agreements/european-union/code-of-conduct-for-business-taxation-and-eu-listing-process-from-2016/

Guernsey

www.gov.gg/economicsubstance

2 Background

In 2016 the EU Council committed to coordinated policy efforts in the fight against tax fraud, evasion and avoidance and adopted the "Conclusions on criteria and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes".

[1] This document issued by Guernsey, the Isle of Man and Jersey, jointly, is to be treated as work in progress and will either be updated or replaced by comprehensive guidance notes which will be published in due course. Any comments should be directed to the respective tax administrations.

[2] In accordance with Guernsey's Regulation 26 of the Income Tax (Substance Requirements) (Implementation) Regulations 2018, Jersey's Article 5(4) of the Taxation (Companies - Economic Substance) (Jersey) Law and the Isle of Man's Section 80M of the Income Tax Act 1970.

In 2016 the Code of Conduct Group were instructed by the EU Council to undertake a screening process whereby jurisdictions, including the Crown Dependencies, were assessed against three standards in respect of:

i) tax transparency,
ii) fair taxation, and
iii) compliance with anti–BEPS[3] measures.

No issues were raised in respect of the Crown Dependencies' standards of tax transparency and anti-BEPs compliance. However, during the screening process the Code of Conduct Group expressed concern that the Crown Dependencies did not have a "legal substance requirement for entities doing business in or through the jurisdiction". The Code of Conduct Group were concerned that this "increases the risk that profits registered in a jurisdiction are not commensurate with economic activities and substantial economic presence".

These concerns were articulated in a letter to each of the Crown Dependencies in November 2017. In response, each of the Crown Dependencies made a commitment to address these concerns by the end of December 2018, which are available at:

Jersey

https://statesassembly.gov.je/assemblystatements/2018/2018.06.26%20minister%20for%20external%20relations%20re%20engagement%20with%20the%20eu%20code%20of%20conduct%20group%20on%20business%20taxation.pdf

Isle of Man

https://www.gov.im/media/1362421/code-of-conduct-group-letter-november-2017.pdf

Guernsey

https://gov.gg/article/162949/statement-from-the-president-of-the-policy-resources-committee

As identical concerns were raised the Crown Dependencies have worked closely together to develop the ~~proposed~~ legislation to address the Code of Conduct Group's concerns. The Crown Dependencies have also prepared this document detailing key aspects and will continue to work together to produce comprehensive guidance notes.

3 High Level Principles

The ~~proposed~~ legislation has been designed to address concerns that companies could be used to artificially attract profits that are not commensurate with economic activities and substantial economic presence in the Crown Dependencies. With this in mind the ~~proposed~~ legislation requires certain companies to demonstrate they have substance in the Island by:

- being directed and managed in the Island;
- conducting Core Income Generating Activities (CIGA) in the Island; and
- having adequate people, premises and expenditure in the Island.

[3] Base Erosion and Profit Shifting ("BEPS")

These substance requirements apply to companies with any income[4] from the following categories of geographically mobile financial and other service activities, identified by the OECD's Forum on Harmful Tax Practices[5]:

- Banking;
- Insurance;
- Shipping;
- Fund Management (this does not include companies that are Collective Investment Vehicles);
- Financing & leasing;
- Headquarters;
- Distribution and service centres;
- Holding Company (a pure equity holding company); and
- Intellectual Property (for which there are specific requirements in high risk scenarios).

These are referred to below as the ~~"geographically mobile business sectors"~~ relevant activities.

All tax resident companies will be required to provide more information in their tax returns to ensure the above activities can be identified.

Tax returns will also be tailored to collect the information needed to monitor compliance with the substance requirements.

4 High Risk Intellectual Property ("IP")

Where a company receives income from IP, it will also have to consider if it is a "high risk IP company", which is defined in the legislation (and see section 6.1 below).

There is a rebuttable presumption that a high risk IP company has failed the substance requirement as the risks of artificial profit shifting are considered to be greater. As a result the competent authority will exchange all of the information, provided by the company, with the relevant EU Member State competent authority where the immediate parent company, ultimate parent company and/or ultimate beneficial owner is resident. Such exchange of information will be in accordance with the existing international tax exchange agreements.

To rebut the presumption and not incur further sanctions (see below), a high risk IP company will have to produce materials which will explain how the DEMPE (Development, enhancement, maintenance, protection and exploitation) functions have been under its control, and that this has involved people who are highly skilled and perform their core activities in the Island.

[4] It is expected that the carrying on of relevant activities will result in the generation of income. If there is any indication that a company is seeking to manipulate or artificially suppress its income to avoid being subject to the substance requirements the respective Tax Administrations will take the appropriate action.

[5] The OECD's Forum on Harmful Tax Practices ("FHTP") is the body that has the mandate to monitor and review tax practices of jurisdictions around the world, focusing on the features of preferential tax regimes for mobile business income which are used for base erosion and profit shifting, and therefore have the potential to unfairly impact the tax base of other jurisdictions. FHTP's priority is on enhancing transparency and requiring substantial activities in preferential regimes

The high evidential threshold requires:

- Detailed business plans which clearly lay out the commercial rationale for holding the Intellectual Property asset(s) in the Island;
- Concrete evidence that the decision making is taking place in the Island, and not elsewhere; and
- Information on employees in the Island, their experience, the contractual terms, their qualifications, and their length of service.

Periodic decisions by non-resident directors or board members, or local staff passively holding intangible assets, cannot rebut the presumption.

5 Directed & Managed

The requirement to be directed and managed in the Island ("the directed and managed test") is a separate test to the case law "management and control" test used in determining the tax residence of a company.

The directed and managed test is designed to ensure that there are an adequate number of board meetings held and attended in the Island (although it is not necessary for all of those meetings to be held in the Island).

What constitutes an adequate number of meetings in the Island will be dependent on the relevant activities of the company. However, it is generally expected that the majority of board meetings will be held in the Island.

It is also expected that even for companies with a minimal level of activity there will be at least one meeting of its board of directors.

The test also looks to ensure that the associated minutes and records are kept in the Island and that the board is a decision-taking body with the necessary knowledge and experience. In the case where there are corporate directors, the requirements will apply to the individual(s) (officers of the corporate director) actually performing the duties.

6 Core Income Generating Activities ("CIGA")

CIGA are the key essential and valuable activities that generate the income of the company.

For each sector the ~~proposed~~ legislation provides a list of the core activities a company operating in such a sector could carry on but ~~.~~ It is not necessary for the company to perform all of the CIGA listed in order to demonstrate substance. Consideration must however be given as to whether the appropriate CIGA are being undertaken in the Island

For example, a company that holds a patent does not have to carry on the CIGA of marketing, branding and distribution as well as the research and development.

Some companies may undertake or outsource all or part of an activity outside of the Island. If that activity is not part of the CIGA this will not affect the company's ability to meet the substance requirement (for example, back office functions, such as IT support).

In addition, the substance requirement does not preclude companies seeking expert professional advice or engaging the services of specialists in other jurisdictions. However, the income subject to tax in the Island must be commensurate to the CIGA undertaken in the Island.

6.1 Intellectual Property ("IP")

For intellectual property assets such as patents, it is expected that the core income generating activities include R&D activities. For non-trade intangible assets such as brand, trademark and customer data it is expected that the core income generating activities include marketing, branding and distribution activities.

However, the core income generating activities associated with an intangible asset will ultimately depend on the nature of the asset and will also depend on how that asset is being used to generate income for the company.

Periodic decisions by non-resident directors or board members, or local staff passively holding intangible assets will not be capable of demonstrating CIGA for IP.

7 Outsourcing

The ~~proposed~~ legislation does not prohibit a company from outsourcing some or all of its activity. Outsourcing, in this context, includes outsourcing, contracting or delegating to third parties or group companies.

If some or all of the CIGA is outsourced, the company must be able to demonstrate that it has adequate supervision of the outsourced activities and, to meet the substance requirements, that those activities are undertaken in the Island.

Where a CIGA is outsourced the resources of the service provider in the Island will be taken into consideration when determining whether the people and premises test is met.

However, there must be no double counting if the services are provided to more than one company.

The company remains responsible for ensuring accurate information is reported on its return and this will include precise details of the resources employed by its service providers, for example based on the use of timesheets.

8 Adequate

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".

What is adequate for each company will be dependent on the particular facts of the company and its business activity. A company will have to ensure it maintains and retains appropriate records to demonstrate the adequacy of the resources utilised and expenditure incurred.

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 legislation (i.e. filing requirements and monitoring by the tax administration).

9 Domestic Reporting

As part of its income tax filing process all companies are require to provide the following details:

- Business/income types in order to identify the type of relevant activity; and
- Amount and type of gross income.~~;~~

In addition, companies carrying on relevant activities will also be required to provide, at a minimum, the following:

- Amount of operating expenditure;
- Details of premises;
- Number of (qualified) employees, specifying the number of full time equivalents;
- Confirmation of the CIGAs conducted for each relevant activity~~.~~;
- The financial statements; and
- Confirmation of whether any CIGA have been outsourced and if so relevant details (see section 7).

10~~9~~ Sanctions and International Reporting

The ~~proposed~~ legislation includes robust and dissuasive sanctions for failure to meet the substance requirements.

The sanctions are progressive and include financial penalties, with the ultimate sanction leading to the striking off of the company from the Companies Register.

The competent authority will also spontaneously exchange relevant information with the EU Member State competent authority where the immediate parent company, ultimate parent company and/or ultimate beneficial owner is resident, if the substance requirement is failed (and in all high risk IP cases – see 4 above).

10 Further Guidance

The tax administrations from the Crown Dependencies will continue to work together to produce comprehensive guidance notes which will be published in due course. The guidance notes cannot, however, cover every scenario and will not replace the need to take independent professional advice.