

Key Aspects - Economic Substance Requirements For Guernsey

17th April 2019

1. Introduction

Like other offshore jurisdictions, Guernsey will be implementing new legislation introducing economic substance requirements for companies in Guernsey. This briefing note sets out key aspects of the Guernsey Government proposed legislation, noting that further, more comprehensive guidance notes, will follow in due course.

The proposed legislation is relevant to all companies resident for tax purposes in Guernsey and **will be effective for accounting periods commencing on or after 1 January 2019**. It is proposed that the Guernsey company tax return will be redesigned as all tax resident companies will be required to provide additional information concerning their activities and income.

Please note that this briefing note should be read in conjunction with the proposed legislation and guidance notes, which can be found at: www.gov.gg/economicssubstance

2. Background

In 2016 the EU Council committed to coordinated policy efforts in the fight against tax fraud, evasion and the Code of Conduct Group ("COCG") were instructed to undertake a screening process whereby jurisdictions, including the Crown Dependencies of Guernsey, Jersey and the Isle of Man, were assessed against three standards in respect of:

- i) tax transparency
- ii) fair taxation; and

iii) compliance with anti- Base Erosion and Profit Shifting (“BEPS”) measures.

No issues were raised in respect of the Crown Dependencies’ standards of tax transparency and anti-BEPs compliance. The COCG, however, expressed concern that the Crown Dependencies did not have a “legal substance requirement for entities doing business in or through the jurisdiction”.

The COCG 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 Guernsey, along with the other Crown Dependencies, made a commitment to address these concerns by the end of December 2018. Accordingly, the Crown Dependency Governments have “worked in close collaboration together” in preparing the respective legislation and guidance notes with the intention of them being as closely aligned as possible. Representatives from the relevant industry sectors have been involved in the preparation of these legislations to ensure that they can work in practice, as well as fully meeting the requirements of the EU.

On 5 November 2018, the draft Income Tax (Substance Requirements) (Guernsey)(Amendment) Ordinance, 2018 (the “Substance Requirements Law” or “SRL”) was published by the Guernsey Government with a view to ensure that Guernsey addresses its commitment in relation to the lack of economic substance requirement for doing business in and through Guernsey.

This briefing note has been prepared to summarise the key features of what is proposed under the SRL.

3. High Level Principles

The proposed SRL 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 Guernsey. 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.

These substance requirements apply to a company resident for tax purposes in Guernsey for the following categories of geographically mobile financial and other service activities referred to as “**relevant activities**”, as identified by the OECD’s Forum on Harmful Tax Practices:

- Banking
- Insurance
- Shipping
- Financing & leasing
- Headquarters
- Distribution and service centres
- Pure Equity Holding Company; and
- Intellectual Property (for which there are specific requirements in high risk scenarios)

Each relevant activity category is defined in the SRL for which further details on specific scope are given in **Appendix 1**.

It is understood that 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 as detailed in “5 Reporting” below.

Please note the following circumstances, where a resident company carries out a relevant activity, would be considered out of scope:

- a) If in any accounting period it has no income generated from a relevant activity; or
- b) Where a company is not resident for tax purposes in Guernsey, even if incorporated in Guernsey. Under the current law, it will be dependent on whether that Guernsey company is claiming residency in another jurisdiction that Guernsey has a double tax agreement (DTA) with, and then depending on the facts of that company and the applicable DTA to confirm the actual residency status. Guernsey has announced that it is reviewing its corporate tax residence rules in light of the new SRL and further guidance is expected during 2019.

4. The Three Substance Tests

Once a Guernsey resident company has been identified as undertaking relevant activities, the SRL requires the company to satisfy the “economic substance test”. This test is split into three parts as detailed below (remembering if no gross income is received in relation to the relevant activity, there is no requirement to meet these tests):

(i) Test 1 – 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 following areas must be considered in applying the directed and managed test:

- *Frequency of Board meetings* – that an adequate number of board meetings are held having regard to the amount of decision-making required at that level. What constitutes an adequate number of meetings will be dependent on the relevant activities of the company. However, it is generally expected that even for companies with a minimal level of activity, there will be at least one meeting per annum of its board of directors.
- *Meetings held in Guernsey* – that there is a quorum of directors physically present in Guernsey. It is not necessary for all of those meetings to be held in the Island but it would be expected that the

majority are. Also, though the SRL refers to the “quorum” of directors being present in the Island, the Guernsey Tax Office have confirmed they would expect to see the majority of the board physically attending in the Island.

- *Minutes and records* – that the associated minutes and records are kept and provide evidence that the board is a decision-taking body making the strategic decisions.
- *Knowledge and expertise of Board* – that the board has the necessary knowledge and expertise to discharge their duties. 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.
- *Records kept in Guernsey* – all minutes and records are kept in Guernsey.

(ii) Test 2 – Core Income Generating Activities (“CIGA”)

For each sector the proposed SRL provides a list of the core income generating activities (which are listed in **Appendix 2**), applicable to each relevant activity that a company operates in, would carry out. The company will therefore need to demonstrate that these core activities are undertaken in Guernsey.

However, it is not necessary for the company to perform all of the CIGA listed, in order to demonstrate substance. 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.

The proposed legislation also 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 (such as a Corporate Service Provider (CSP)) or group companies. What the Guernsey company has to be able to demonstrate is that it has adequate supervision and control 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 CSP 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 CSP, for example based on the use of timesheets.

Note, where outsourced 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.

The key point to note is that the income subject to tax in the Island must be commensurate to the CIGA undertaken in the Island.

(iii) Test 3 – Adequate Resources

The company has to demonstrate that in relation to the level of relevant activity carried on in Guernsey that there is adequate:

(a) Employees – The Company has an adequate level of (qualified) employees in the jurisdiction proportionate to the activities of the company.

(b) Expenditure – An adequate level of annual expenditure is incurred in the jurisdiction proportionate to the activities of the company.

(c) Premises – Adequate physical offices and/or premises in the jurisdiction from which it can carry out the activities of the company.

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 expenditures incurred.

5. Reporting

The SRL requires a Guernsey company to provide to the Guernsey Income Tax Office any information that is reasonably required to assist the Director of Income Tax in determining whether or not a resident company has met the economic substance test. Although the legislation is currently silent on what type of information is required,

industry advisors have indicated that this information will be collected through the company's annual tax return and that the following are details that are likely to be requested:

- Business activities;
- Amount and type of gross income;
- Amount and type of expenses and assets;
- Premises;
- Number of employees specifying the number of fulltime equivalent employees with the necessary qualifications.

6. 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 (as detailed below), the possible request for an audit where continued non-compliance is identified, 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. In all high risk IP cases exchange of relevant information will automatically occur (see **Appendix 1 "Intellectual Property"** for further details).

The financial penalties in Guernsey for failing the economic substance test are:

- i) For first accounting period failure, a penalty not exceeding £10,000;
- ii) For its third accounting period failure, a penalty not exceeding £50,000; and
- iii) For its fourth accounting period failure, a penalty not exceeding £100,000.

7. Further Guidance

The tax administrations from the Crown Dependencies will continue to work together to produce comprehensive guidance notes which will be published in the near future.

However, these will not possibly be able to cover every scenario and will not replace the need to take independent professional advice.

A useful substance requirements flowchart as produced in the Crown Dependencies guidance notes has been attached at **Appendix 3**.

8. Conclusion

Companies operating in relevant sector industries are now under pressure to ensure that they comply with the new legislation which will commence at the start of 2019.

This will have a significant affect upon many Guernsey businesses who have only a short amount of time to demonstrate to the authorities that they are compliant. The potential penalties of non-compliance may cause detrimental reputational risk, fines of up to £100,000 and could even cause a company to eventually be struck off.

◦ **Where does this leave us?**

All companies must consider whether they fall within the relevant sectors, and where they do, will need to consider and asses their position. If a company does not fall within a relevant sector, then there are no obligations falling upon them by the proposed SRL.

Many companies will easily be able to identify whether or not they fall within a relevant sector and companies managed by CSPs may need to assess whether they have the necessary substance.

◦ **What might change?**

We are on the brink of Brexit and, to date, much of the discussions have taken place with the EU commission and the draft legislation has been reviewed by them; however, the COCG will only meet to discuss such matters in February 2019.

It therefore remains to be seen whether the COCG agree that the proposals go far enough. What is clear, is that this legislation is here to stay in some shape or form and therefore companies need to consider their position as soon as possible.

- **How can we help?**

If you think that your business may be affected by the new legislation, it is important that you begin assessing and taking appropriate action now. Please contact the Dixcart office in Guernsey to discuss substance requirements in more detail:

advice.guernsey@dixcart.com.

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Appendix 1

Relevant Activity Definitions

Each relevant activity category is defined as follows in the SRL for a company resident for tax purposes in Guernsey:

Banking

Means the carrying on of banking business as regulated by the Banking Supervision (Bailiwick of Guernsey) Law, 1994.

Insurance

Means the undertaking of insurance business within the meaning and under the licence of the Insurance Business (Bailiwick of Guernsey) Law, 2002.

Shipping

Is defined in the SRL as any vessel larger than 24 meters operating in international waters (i.e. not in the Bailiwick of Guernsey waters) for income, for the transport of passengers or cargo including the following activities:

- The rental on a charter basis of the ship;

- The sale of tickets or equivalent and the provision of services connected with such sales;
- The use, maintenance or rental of containers (including trailers and other vehicles or equipment used for the transport of containers) used for the transport of goods or merchandise; and
- The management of the crew of a ship.

Finance and Leasing

Is defined as a company providing credit facilities of any kind for consideration to any person (a "customer"). It includes the provision of credit by way of instalments for which a separate charge is made and disclosed to the customer in connection with:

- The supply of goods by hire purchase;
- Financial leasing (excluding land and interests in land); and
- Conditional sale or credit sale.

Headquarters' Business

Means the provision by a Guernsey resident company to non-Guernsey resident intra group persons of the of any of the following services:

- The provision of senior management;
- The assumption or control of material risk for activities carried out by, or assets owned by, any of those group persons; and
- The provision of substantive advice in relation to the assumption or control of risk for such activities or assets mentioned above.

Distribution and Service Centres

Means a business of which the sole or main activity is:

- The purchase or raw materials and finished products from other members of the same group which are non-resident in Guernsey and to re-sell them for a small percentage of profits; or
- The provision of services to other members of the same group which are not Guernsey resident.

Holding Company

Where it is a Guernsey resident company which broadly holds the majority shares in another entity; has as its primary function the acquisition and holding of shares or equitable interests in other companies; and which does not carry on any commercial activity.

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.

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. 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 the employees in Guernsey, their experience, 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.

Appendix 2

Core Income-Generating Activity (CIGA) Definitions

For the purposes of the Regulations “core income-generating activity” in relation to each relevant activity that is being undertaken in Guernsey has been defined as follows:

Banking

In relation to banking, includes:

- managing risk including credit, currency and interest risk;
- taking hedging positions;
- providing loans, credit or other financial services to customers;
- managing regulatory capital; and
- preparing regulatory reports and returns.

Insurance

In relation to insurance, includes:

- predicting and calculating risk;

- insuring or re-insuring against risk; and

- providing client services,

Finance and Leasing

In relation to financing and leasing, includes:

- identifying and acquiring assets to be leased (in the case of leasing);
- setting the terms and duration of any financing or leasing;
- monitoring and revising any agreements; and
- managing any risks.

Headquartering

In relation to headquartering, includes:

- taking relevant management decisions;
- incurring expenditures on behalf of group entities; and
- co-ordinating group activities.

Shipping

In relation to shipping, includes:

- managing crew (including hiring, paying and overseeing crew members);

- hauling and maintaining ships;
- overseeing and tracking deliveries;
- determining what goods to order and when to deliver them; and
- organising and overseeing voyages.

Distribution and Service Centres

In relation to distribution and service centres, includes:

- transporting and storing goods, components and materials;
- managing stocks;
- taking orders; and
- providing consulting or other administrative services.

Holding Company

All activities related to that business.

Intellectual Property Assets

In relation to intellectual property assets, includes:

- research and development (rather than acquiring or outsourcing);
- marketing, branding and distribution;

- taking the strategic decisions and managing (as well as bearing) the principal risks relating to the development and subsequent exploitation of the intellectual property asset;
- taking the strategic decisions and managing (as well as bearing) the principal risks relating to the third-party acquisition and subsequent exploitation of the intellectual property asset; and
- carrying on the underlying trading activities through which the intellectual property asset is exploited and which lead to the generation of revenue from third parties.

Appendix 3

Substance Requirements Flow Chart



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