

The economic substance rules – What's happening?

15 FEBRUARY 2019

CATEGORY:
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In response to the concerns raised by the EU Code of Conduct Group ('Code Group'), a number of British Overseas Territories (including the Cayman and British Virgin Islands) and Crown Dependencies (including Jersey and Guernsey) are enacting legislation relating to the economic substance of companies (and, in some cases, limited partnerships).

The Code Group reviewed the tax regimes applicable in over 90 jurisdictions. Whilst it found that many international financial centres were generally compliant with EU principles relating to tax policy, concerns were raised regarding the absence of a legal substance requirement for doing business in, and through, certain jurisdictions.

The BVI, the Channel Islands and other jurisdictions including Bermuda, the Cayman Islands, and Isle of Man, were included in a list of jurisdictions which were required to address the Code Group's 'economic substance' concerns. The governments of these jurisdictions actively engaged with the Code Group in terms of introducing a legislative response.

The purpose of the legislation is to ensure that companies (and certain other entities) incorporated in international financial centres have sufficient 'substance' either in the jurisdiction in which they are incorporated, or another jurisdiction where they are tax resident. These measures are designed to discourage the use of 'brass plate' companies and nominee directors.

What are the requirements?

Although there are variations as to how each relevant jurisdiction has legislated to address the 'economic substance' concern, the approach has been broadly consistent. Where there are now substance requirements, the requirements do not apply to all entities: rather, they apply to those carrying on certain 'relevant activities'.

A range of entities are within the list of those carrying on 'relevant activities' including those carrying on (1) banking business, (2) insurance business, (3) fund management business, (4) finance and leasing business, (5) intellectual property business and (6) holding company business. There are specific definitions of each of these activities. Guidance on the meaning of the terms is likely to be available in each of the affected jurisdictions shortly.

Where an entity is formed within a relevant jurisdiction and it is not carrying on a 'relevant activity', it is not subject to the substance requirements imposed by the applicable legislation. An example of such a company would be one holding personal use real estate. Family investment companies and private trust companies may also fall outside the rules (although guidance is awaited in this respect).

If an entity is formed within a relevant jurisdiction and it is carrying on a 'relevant activity', it must meet the substance requirements, unless it can show that it is tax-resident in another jurisdiction. Failure to meet the requirements will result in substantial fines and/or the company being struck off.

The 'substance' requirements

Each affected entity which is not tax resident elsewhere must demonstrate adequate 'substance' in its jurisdiction of formation. The substance required will turn on the activity being performed (having regard to the nature and scale of the relevant activity) but of relevance will be whether, from that jurisdiction, (1) activities are being directed and managed, (2) there are adequate numbers of employees, (3) there is adequate expenditure and (4) appropriate physical offices or premises.

What to do now?

Guidance is due to be issued shortly and substantive steps may not be taken before that is in place. However, the rules will be fully effective later this year and so preliminary work to identify affected entities should be undertaken now.

1. Firstly, consideration should be undertaken to ascertain if a company or other legal entity which may be affected is carrying on a 'relevant activity'.
2. If it is, there will in most cases be two possible responses if a view is taken that the entity does not have sufficient substance:

- (1) it must develop more local substance; or
- (2) it must become tax resident in another jurisdiction.

The response to the substance rules does require an international perspective as, for many companies affected, a review of their tax residency position globally will be required. Planning in relation to the substance rules could also impact on the position of affected companies both under the Common Reporting Standard and FATCA.

For further assistance on this issue, please contact your usual Withers contact or:

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