

Q&A – Substance legislation: scope, tests and sanctions

Insights - 11/02/2019

This Q&A sets out an overview of substance legislation across our jurisdictions, with particular relevance to questions about how the law came about, the scope of the law, the definitions attached to the tests involved, and sanctions for non-compliance.

Why are Jersey, Guernsey, BVI and Cayman (among others) implementing these changes?

Following a review by the EU's Code of Conduct Group in 2017 to assess standards of tax transparency, fair tax and compliance with measures to prevent base erosion and profit shifting (which is the subject of the OECD's BEPS project), BVI, Cayman, Guernsey and Jersey were re-affirmed as co-operative jurisdictions, but the European Commission highlighted concerns about the ability of the Crown Dependencies and British Overseas Territories (which include the Cayman Islands and the British Virgin Islands) to demonstrate that companies tax resident in their jurisdictions operated with sufficient physical substance to justify their profits.

What happens next?

The Crown Dependencies, the Cayman Islands and British Virgin Islands, as well as other non-EU jurisdictions including Bahamas, Bermuda and Mauritius, made a commitment to the European Commission to address their concerns by the end of 2018. The resulting rules require companies that are tax resident in any of the jurisdictions, and generating income from their engagement in certain relevant activities identified by the EU, to confirm each year that they meet minimum substance requirements with effect from financial years beginning in 2019. European Commission civil servants are reviewing the legislation and EU Member States' Economic and Financial Affairs Council (ECOFIN) will then make decisions based on the Commission's analysis through the Council of the European Union's Code of Conduct Group which is expected to occur either on 12 February or 12 March.

Do the new rules apply to all companies?

The substance rules apply to companies carrying on relevant activities. These are:

- Banking
- Insurance
- Fund Management
- Finance and Leasing
- Shipping
- Headquarters Activities
- Distribution and Service Centre Activities

In addition, specific rules apply to:

- pure equity holding companies; and
- intellectual property asset holding companies.

Do the rules only apply to companies?

In most jurisdictions, the rules only apply directly to companies; however, there is some difference between the jurisdictions in this regard and specific advice should be sought.

Are certain activities out of scope?

The EU, in its initial report, specifically excluded certain categories of activity from the scope of the requirements, including the activities involved in being a collective investment scheme. There is some difference between how this has been applied in each jurisdiction and specific advice should be sought regarding whether a company's activities are in scope or out of scope.

If a company is carrying on relevant activities, what does it need to do?

Each category of relevant activity, other than that covering pure equity holding companies, has a list of core income generating activities that are expected to be carried on by that entity in the jurisdiction in which they are tax resident and all companies that are in scope are expected to have board meetings held in that jurisdiction, as well as keep certain records there and be directed and managed from that jurisdiction. Companies carrying on relevant activities are also expected to have an adequate level of staff, premises and expenditure in the relevant jurisdiction, proportionate to the activities carried out in that jurisdiction.

The precise requirements and the interpretation of the concepts 'adequate' and 'proportionate' require detailed analysis on a case by case basis and so specific advice should be taken on how this may apply to your business.

Our team of experts can advise you further on how these requirements affect your companies based in Guernsey, Jersey, British Virgin Islands and Cayman islands.

What if my company does not have any income in a tax year?

Generally, for a company to be in scope of the legislation, it will need to have received income from the relevant activity during the relevant tax year. However, fact specific advice should be taken in this regard.

What are the sanctions for non-compliance?

The sanctions vary by jurisdiction, but generally allow the tax authorities to report the offence to other relevant tax authorities, including those of the company's parent (where it is situated in an EU jurisdiction) and follow a pattern of progressively punitive sanctions, ranging from fines to requiring the company to be struck off.

Bulletin on the 2020 Guernsey Substance Amendment Regulations and the treatment of funds under the substance regime can be [found here](#).

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